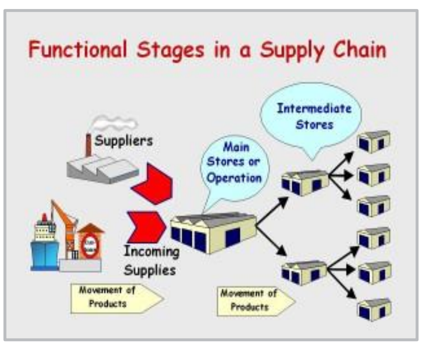
SECURED LENDING

Adoption of the UCC principles in establishing a Security Interest



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Overview

Security, or collateral, consists of assets pledged by a borrower to a lender to protect the lender from loss. Security may also be taken by a seller of the goods on credit, where the seller requires some protection in the event that his customer is unable to pay. The taking of security is a long standing device used by bankers to protect themselves from loan losses because it provides an ultimate source of payback—i.e. sale of the assets pledged as security. Secured lending comprises a wide range of lending vehicles and types of collateral, but common to all is the presence of some kind of security.

Characteristics of Security

Collateral taken as security for a bank loan should have the following characteristics:

- easily ascertainable value (to allow an ample margin of protection to be taken)
- ready sale or realization (to allow immediate recovery of the loan principle and, ideally, interest)
- no encumbrances (i.e., prior liens or claims)
- cheap and easy transfer (to facilitate perfection and relinquishment of the collateral)
- safe and simple title (to ensure an indisputable interest in the collateral).

Types of Security

Typical forms of collateral used in personal and commercial lending include the following:

1. Assignment of accounts receivable.
2. Assignment of inventory through title documents covering merchandise in warehouse or in transit. Such title documents may be warehouse receipts, bills of lading and other related instruments.
3. Assignment of marketable securities (bonds or stock).
4. Assignment of cash balances and savings passbooks.
5. Assignment of the cash surrender value of life insurance policies.
6. Real estate mortgages or assignment of leases on real or personal property.
7. Assignment of contract moneys.
8. Chattel mortgages over equipment or inventory items.
9. Assignment of futures hedging accounts.

This paper is concerned primarily with considerations and procedures for administering and monitoring asset protection loans that are secured by the pledge of accounts receivable and/or inventory and the principles contained in the UCC with regard to the perfection of the security interests.

Specifically, we will be dealing with methods for achieving and maintaining seniority, protection, and control under each of these loans.

However, before turning to a detailed discussion of the specific financing vehicles, we will first review the law governing secured transactions in general and the procedures for establishing a security interest that apply to most types of collateral under the UCC.

Secured Financing - The UCC

Most commercial transactions in the United States are governed by the Uniform Commercial Code (UCC) which was primarily developed to simplify, modernize, and clarify the commercial law relating to commercial sales. Its main objective was to reduce legal uncertainties and to harmonize the commercial law throughout the United States

Although it is not applicable per se outside the United States, the principles established thereunder are generally of great commercial importance and guidance.

In particular, Article 9 of the UCC which covers secured transactions and provides the effective legal procedures for their regulation is of importance. Unlike the previous body of law governing secured transactions, which differentiated between various types of secured transactions and often made it legally difficult to extend secured financing; Article 9 recognizes that in every secured transaction goods are used to collateralize a loan. If the lender is not paid according to the agreed upon terms, he may take over the goods and dispose of them in settlement of the debt. Article 9 defines a "security interest" as existing whenever goods serve as collateral for payment or performance of an obligation. It should be emphasized that the requirements for establishing and maintaining a valid security interest may be legally complicated and legal counsel should, at all times, be consulted.

Once the decision to lend on a secured basis has been made, collateral must be identified and a security interest in the collateral must be established. To obtain a security interest and to ensure that the lender's rights to collateral will not be jeopardized by the borrower, his creditors, or third parties, a lender must create and perfect a security interest following the requirements outlined in Article 9 of the UCC.

Creating the Security Interest

The Security Agreement

To create a security interest, a security agreement must first be obtained. A security agreement is a contract between a borrower and a lender, in which the debtor assigns property to the creditor as collateral for the loan and in which the lender agrees he does not own the property and the collateral is taken only the repayment of the loan. The security agreement must:

a. be in writing
b. be signed by the debtor
c. describe the collateral

A security agreement may create a security interest in specified goods, or, alternatively, it may create a floating lien or fixed lien on the firm's assets:

- A **floating lien** establishes a security interest not only in specified assets owed by the debtor at the time of the agreement, but also in any similar assets acquired by the debtor after the agreement has been signed. This type of lien is created by the inclusion of an "after-acquired property" clause in the security agreement. It is called a floating lien because it "floats" forward in time to cover assets as they turn over in the normal course of business. The floating lien provision is particularly important in the financing of inventory where the debtor's merchandise is constantly moving from the shelves of the debtor to the ultimate consumer and is being replaced by new merchandise. It is also important in accounts receivable financing where accounts are being paid off and ones generated.

- A **fixed lien** establishes a security interest in all of a borrower's assets (except real estate, vessels, aircraft and other assets that are outside the jurisdiction of the UCC). A fixed lien also includes an after-acquired properties provision, so that it covers all presently owned assets, as well as any that may be acquired in the future.

Other clauses in the security agreement may provide for the disposition of proceeds from sale of collateral and for dominion over the collateral.

- **Disposition of Proceeds.** When financing assets that are ultimately to be sold, the security agreement should create a security interest not only in specific assets but also in the proceeds from the sale of the assets. In describing the collateral in the security agreement, the use of the word "proceeds" is sufficient to obtain a security interest in proceeds of any type (i.e. cash or accounts receivable).

- **Dominion Over Collateral.** A security agreement may allow a debtor to use, comingle, and sell any part of the collateral. Hence, the debtor may have actual dominion over the collateral that has been pledged to the bank. When the debtor is allowed dominion over the collateral, provision should be made in the security agreement requiring the borrower to turn over proceeds from the sale of the collateral promptly to the bank.

Documentation

The following documents are commonly used at Banks to effect a security agreement.

- **Security Agreement** refers to specific collateral that the borrower is assigning to the bank.
- **General Security Agreement** constitutes bank's fixed lien in which all of the borrowers' assets are assigned to the bank. The "after-acquired property" clause is also included.
- **Loan and Security Agreement**: Inventory and Accounts Receivable is a specialized loan agreement and security agreement for use in financing inventory and accounts receivable. It includes the: "after-required property" clause.
- **Collateral Promissory Note:** combines the promissory note ant the security agreement. It is commonly used in the for loans against marketable securities and other possessory collateral. *

Attaching the Security Interest to the Collateral

Under the UCC, the property assigned as collateral in the security agreement becomes subject to the security interest (i.e., the security interest attaches to the specific item of collateral) when the following requirements have been met:

1. There is a valid security agreement.

2. The debtor has ownership and/or assignable right to the collateral.

3. Value is given to the debtor by the secured party, i.e., the loan is made.

Perfecting the Security Interest

A security interest in itself is of limited value if it is not enforceable against third parties, such as other secured creditors, other unsecured creditors, certain purchasers of the debtor's property, or a trustee in bankruptcy. To ensure that it will be enforceable against any such the third party claims, the security interest must be perfected, that is, other parties must be notified of the security interest. Procedures for perfecting a security interest differ depending on whether the collateral is possessory or non-possessory:

1. In the case of possessory collateral, where the bank has physical possession of the collateral or the titled document evidencing ownership, no further action is required to perfect the bank security interest. Possession of the collateral suffices to perfect the bank's security interest in the collateral, and no other creditor will be able to enforce claims against it.

2. In the case of non-possessory collateral, where the collateral or title documents are not in the physical possession of the bank, a security interest must be perfected. To perfect a security interest in accounts receivable as non-possessory collateral, it is necessary to file a financing statement only in the state where the borrower's headquarters or main administrative office is located. To perfect a security interest in inventory to which the bank does not have title documents (possessory collateral), it is necessary to file in every place where the borrower maintains storage facilities.

The filing of a financing statement constitutes public notice that a security interest has attached to certain goods. Any potential lender or other interested parties can check public records to see whether a prior lien exists on goods that they are about to finance or acquire.

The financing statement must be signed by the debtor and the secured party, show the address of both parties, and contain a statement indicating the type of collateral (a general description of the goods is adequate). A copy of the security agreement may serve as a financing statement if it contains the required information and if it is signed by both parties. A single financing statement is valid for five years and can cover a number of separate transactions between the bank and a borrower; a new financing statement need not be filed each time the borrower signs a security agreement, unless a different typed of collateral is involved.

First-to-File Rule

Under the Code, the first creditor to perfect a security interest with respect to a particular type or class of collateral, by filing a financing statement, has senior claim to that collateral in liquidation. The financing statement, therefore, should be filed as early as possible in the transaction, preferably before any loan proceeds are disbursed. [It is permissible to file even before a security agreement exists. No actual loan has to be made (hence no actual security interest has to exits) prior to filing.]

Before filing, a search of the records should be conducted to check for prior filings. This practice is generally followed in most jurisdictions under the particular local laws which adopt the same approach as the UCC.

In the event that other lenders have already filed with respect to the specific collateral, the bank should attempt to negotiate an inter-creditor agreement with the other lender. The inter-creditor agreement Bank is designed to bring two or more banks into equal position with regard collateral, in which they do not have a purchase money security interest, even though they may have perfected their security interest at different times. The inter-creditor agreement allows the bands to share in the proceeds from collateral liquidation on a pro-rata basis according to their relative claims.

Exceptions to First-to-File Rule

Exceptions to the first-to-file rule of the UCC, which accords priority to the claim of the creditor who has filed first, are made in the case of the purchase money security interest, the trust receipt, and in bankruptcy where preferential transfer has taken place:

- **Purchase Money Security Interest.** A seller of goods who, in lieu of immediate payment, takes a security interest in the goods sold or a lender who finances the purchase of a specific, identifiable asset and who takes a security interest in that asset is said to have a purchase money security interest. A purchase money security interest provides the seller or the creditor an exclusive security interest in the specific asset. To perfect such a security interest, a financing statement must be filed within ten days of the purchase of the asset, except for inventory when the filing must take place when the inventor is received. (If however, the seller or creditor has possession of the title document, filing is not necessary to perfect the security interest.) When the purchase money security interest has been perfected by filing, the seller or creditor is given priority with regard to that asset (and only that asset) even if another creditor has previously filed a floating or plaster lien on all the debtor's assets.

- **Trust Receipt**: Sometimes when the bank has a security interest in inventory goods stored in a warehouse, it may need to authorize the release of the goods before they can be sold and payment received. The bank automatically retains its security interest in goods released on trust receipt for 21 days, unless the goods sold, in which case the bank must demand and receive payment within 10 days or sale or lose its security interest. After 21 days it must perfect its security interest by filing a UCC financing statement. (Trust receipts will be discussed in detail in a later section.)

Applying UCC Rules to Different Types of Collateral

Since the real innovation of Article 9 lies in its functional treatment of collateral and secured transactions, the first step to be taken in analyzing a proposed loan is to determine which Code category of collateral is to be taken as security. From this determination will follow a set of governing rules which will allow a lender to obtain a clearly defined security position. This can now be done in a much simpler manner than was the case under pre-Code law.

The UCC differentiates between three broad classifications of collateral:

- Tangibles (such as inventory and equipment)
- Intangibles (such as accounts receivables and contract rights)
- Semi-intangibles (such as documents of title ad negotiable instruments)

Tangibles

Tangible goods serving as collateral often have to be in the physical possession of the borrower. Inventory, for example, must usually be under the control of the borrower since it consists of raw materials awaiting production, goods in process, or unfinished goods awaiting sale. The perfect a security interest in such tangible goods that are not in the possession of the lender a UCC Financing Statement must be filed with the appropriate place authority.

The financing of inventory as non-possessory collateral presents more intricate legal problems than other types of financing because:

- The fungible nature of many types of inventory may make it difficult to identify, and inventory parts serving as collateral may become commingled with other parts.
- The normal course of business requires that inventor eventually be sold to buyers who want good title to the goods purchased and who do not want to search records for liens on the goods.
- The sale of inventory creates proceeds in the form of cash or accounts receivable, or the manufacturing process creates products of inventory. (Inventory that began as leather ends up as shoes.)

The problem of creating and perfecting a valid security interest in inventory as non-possessory collateral were never really solved by pre-Code legislation. In many court decisions the security interest was invalidated if the debtor was permitted to sell his inventory without turning over the proceeds of the sale in the form received to the secured party. Or, if identity of the goods was lost either through commingling, processing, or sale, the security interest in the goods, under pre-Code law, was jeopardized. Due to the policing procedures required, the financing of inventory was usually an expensive proposition.

The UCC has largely clarified the legal ambiguities regarding inventory as collateral and has greatly amplified the financing of inventory.

- Under the Code, a security interest in inventory is not invalid against creditors by reason of the debtor's freedom to sell the inventory or by reason of the debtor's not accounting for the proceeds of sale.

- By including an "after-acquired property" clause in the security agreement, a lender can make new advances as a borrower acquires new inventory, and there is no need to enter into a separate security agreement each time inventory turns over.

- The UCC recognizes the establishment of a security interest not only in the inventory goods that are being financed but also in the final products resulting from further processing and in the proceeds resulting from the final sale of the goods. When filing a financing statement to prefect a security interest in inventory, the bank should indicate on the financing statement (by checking the appropriate boxes) that it is also taking a security interest in any products and proceeds. If the bank does not claim a security interest in the proceeds when it filed its initial financing statement, a security interest in the proceeds is automatically perfected for ten days from the sale of the inventory. To continue the security interest beyond ten days, however, an additional financing statement covering inventory and proceeds should be filed.

- Under the UCC, the creditor has no legal rights against a buyer who purchases the inventory in the normal course of business. The buyer takes title to the purchased goods, but the creditor has a legal right to the proceeds. The creditor should, therefore, make sure that all proceeds are promptly turned over.

Intangibles

A security interest in accounts receivable and other intangibles cannot be perfected by taking possession of the collateral because of their nature (by definition, accounts receivable are evidenced by unsupportable or adjustable documentations, such as shipping invoices or purchase orders). A security interest in accounts receivable must be perfected by filing a financing statement in the place in which the seller maintains his main place of business and where he keeps his books and records.

Frequently in financing accounts receivable the seller, i.e., the bank's debtor, is required to make collections and to dispose of returned or repossessed goods. In most court decisions under pre-Code law, a security agreement that gave the debtor any such authority was invalid unless the debtor was required to turn over all collections in the form received to the secured lender and the secured lender actually policed the transaction to make sure that no collections or returned merchandise were commingled with the debtor's funds or property. Under the Code, the debtor may be given complete freedom to make collections and to dispose of returned merchandise without voiding the security agreement. However, good credit control procedures require the borrower to turn over in the form received all proceeds from the collection of accounts receivable. That is, the borrower should not cash the checks received from the customer but should endorse them and turn them over promptly to the bank.

A conflict of security interest arises when one creditor finances receivables and files against them, while another finances inventory and files against inventory, products and proceeds of the same debtor. To avoid such a conflict, some lenders file against inventory products and proceed, even though they are only financing receivables. Banks should be on guard and in such situations obtain an inter-creditor agreement.

Semi-intangibles

A security interest in semi-intangibles, such as negotiable documents of title, is perfected by possession of the document. The filing of a financial statement is not required (unless the creditor releases the title document against a trust receipt, in which case a financing statement must be filed after 21 days in order to perfect the security interest).

Summary

The adoption of the UCC has had a major impact on many secured lending techniques, particularly in the areas of accounts receivable and inventory financing. It was formerly difficult to extend secured credit, because there were few well-defined, uniform security devices. Among the significant changes brought about by Article 9 of the Code are the provisions permitting the secured party (a) to obtain a security interest in after-acquired property, (b) to allow the debtor to have complete freedom in disposing of property subject to security interest, and (c) to describe collateral in general terms in the financing statement.

Before turning to a detailed discussion of accounts receivable financing, warehouse receipt financing, and trust receipt financing, we will first introduce the concept of borrowing base, which is integral to the financing of account receivable and inventory.