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EVIDENCE OF COLLATERAL

Numerous federal and state statutes govern the documentation of collateral. The reason so many diverse laws are involved is the seemingly infinite list of assets that can be pledged as security for a commercial loan. Different laws govern documentation for the various types of collateral securing commercial loans.

Broad classifications of collateral

1. Real property is land, buildings, and any attachments. State law governs taking a security interest
2. Personal property is any other property, including business assets such as inventory. Article 9 of the Uniform Commercial Code (UCC) governs taking a security interest in most types of personal property. Further, the UCC recognizes the following two types of personal property:
 - A. Tangible property or goods, which are all things movable at the time the security interest attaches, or fixtures. Goods include consumer goods, farm products, inventory, and equipment
 - B. Intangible property is categorized by its characteristics, not by its use. Intangibles include accounts, instruments, chattel paper, documents, money, and general intangibles

Article 9 of the Uniform Commercial Code (UCC) covers taking a security interest in most types of personal property. Article 9 is based on the premise that all banks have certain rights when holding an interest in property pledged as security for a loan. Chief among the rights is allowing a creditor to retain an interest in the collateral, even if its form changes. For example, if a loan to a furniture maker is secured by inventory of oak lumber, under Article 9 the creditor's interest can remain with the property (provided certain conditions are satisfied) as the wood is made into chairs, and as the chairs are sold for cash or accounts receivable. Therefore, from the perspective of both borrower and bank, Article 9 can provide a measure of certainty and uniformity to the commercial lending process. For business bankers to create a legally enforceable right to the property under UCC Article 9, the collateral must be identified first, rights established, and the security interest attached and perfected.

Major revisions were made to Article 9 in 1998 and implemented in 2001. Minor changes were made after that, and a number of more significant amendments were approved by the Uniform Law Commission in 2010. The 2010 amendments modify the existing statute to address certain filing issues and to accommodate developments in secured transaction practices after more than a decade of experience with the 1998 revisions. Most important, the 2010 amendments provide additional guidance regarding the name of the debtor to be provided on a financing statement. The uniform effective date of the 2010 amendments was July 1, 2013. All states have adopted revised Article 9 in some form, but the subsequent changes have not been enacted in all states, and many have modified the standard version. You should consult with your bank's loan policy or documentation policy, as well as legal counsel, concerning UCC laws in effect for various transactions. This course focuses on the standard, revised version.

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Before a bank can take possession of property securing a loan, the bank or any other creditor must show that its right to the property is superior to the owner's right. This right is referred to as having a security interest in the property. To create a bank's interest in the property securing a loan, a business banker must first take **steps prior to establishing rights to the collateral** by identifying the ownership and type of collateral. Knowing whether the collateral is owned free and clear is essential, and determining the type of collateral is important because of the different treatments under the law.

Next, a business banker must establish the bank's right to the borrower's property. This is accomplished by attaching the bank's security interest, and the principal document for doing this is the security agreement.

Finally, if the bank wishes to establish a right to the property that takes precedence over other possible creditors, the security interest must be perfected. This is generally done by either taking physical possession of the collateral, by taking control over the collateral, or by publicly filing a notice of the security interest through a financing statement. In certain transactions, perfection also occurs automatically when the security interest is attached.

Identifying the collateral

Because the owner is the only party who legally can pledge collateral as security for a loan, the first step in creating a security interest in collateral is to correctly identify its owner. Most lenders avoid attaching and perfecting a security interest in a property that is owned by someone else. They also avoid property already encumbered by a lien or other security interest, unless the intent is to take a secondary or subordinate lien on the property.

Proof of ownership on titled property is easy to obtain. For non-titled property, such as equipment, existing business records (tax depreciation schedules) help verify ownership. To verify a lien or security interest, a business banker may need to search UCC filings; property, state, and federal tax records; real estate records; and court records. A lien check should reveal creditor names and outstanding loans against the collateral as well.

Identifying the legal classification of collateral is equally important. It can be a deciding factor in determining how the collateral is attached and perfected, plus the documents needed to accomplish this. For example, because accounts receivable are covered under UCC Article 9 (defined under the code simply as "accounts"), a security interest is created by using a security agreement for attachment, then filing a financing statement for perfection. Real estate, on the other hand, is governed by state statutes, with attachment and perfection accomplished in most states by the creditor holding and filing a mortgage or deed of trust.

Preparation steps prior to establishing rights to collateral

A business banker and/or loan documentation staff or outside legal counsel should do the following prior to establishing rights, attaching, and perfecting the collateral:

- Understand and diagram the transaction
- Correctly and completely identify the debtor, the collateral, and other critical information
- Identify the collateral that is perfected exclusively under Article 9
- Determine whether the debtor has rights in the collateral
- Know when to ignore contractual restrictions on transfer
- Understand the importance and implications of correct collateral categorization
- Decide how best to perfect—whether by possession, control, or filing
- Determine where to file for collateral that is not real estate-related
- Determine where and how to file for real estate-related collateral
- Determine where to search for previously filed financing statements
- Learn how to review search results
- Understand what can prevent the termination statement from becoming effective

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Personal property covered by UCC Article 9 generally is grouped under goods and intangibles. Within those general classifications are differentiations, and each one is important in determining how a security interest is attached and perfected. When creating a security interest in collateral, business bankers refer to their state's Uniform Commercial Code.

The code does not cover some types of personal property and real property. For collateral of this nature, a business banker refers to appropriate federal or state statutes to determine how to attach and perfect the security interest.

Attaching the security interest

In secured lending, a bank demonstrates its right to the collateral. If no right is established, then a borrower could at some point sell the collateral and leave a bank with no recourse if the terms and conditions of the loan are not met. A bank's right to the collateral depends on whether a security interest has been attached and perfected. An attachment (legal binding) of a security interest requires the following three items to be in force:

- The borrower and the bank must have a written agreement that states the bank has a security interest in the property
- The bank must give something of value in consideration (in return), such as money or a commitment to lend
- The borrower must maintain rights in the collateral either through ownership or ability to assign rights

Although technically covered, oral agreements are difficult to enforce. With any loan, a bank's risk is reduced significantly when it has possession of the collateral. Possession eliminates the possibility that collateral will be sold or lost. Physical control of collateral is feasible only when it can be handled easily by the bank. For most forms of collateral, however, it is impractical to take physical possession. Equipment is expensive to warehouse and is needed to operate the business in order to generate cash to repay the loan. Other types of collateral such as accounts (accounts receivable) cannot be held. The bank, therefore, must obtain a security agreement.

A security agreement can be in many forms, but its provisions must comply with the lender's state UCC for personal property or applicable federal or state law (for non-UCC personal property and real property). Unless the collateral is perfected through possession or control, and other requirements are met, the code requires a security agreement to attach the security interest.

A security agreement usually is a separate document, and the wording corresponds exactly to the promissory note and financing statement. If the loan amount on a promissory note is \$400,000, it must not be \$40,000 on the security agreement. Other requirements, such as those necessary to enforce the document, should be satisfied as well.

Once all applicable information is entered, the security agreement is then signed by authorized individuals. Often, the wording on the security agreement states that the agreement secures the note and any other debt the borrower has the bank, now or later. A security agreement also can pledge present and future assets. For example, it can stipulate that all inventory now owned or later acquired constitutes security for the loan. Other terms in the security agreement include additional representations, warranties and agreements; lock box collection of payments on accounts, a collateral deposit account, account verification and collection rights of the secured party, assignment of insurance, events of default, and remedies.

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Perfecting the security interest

Perfection creates a security interest in collateral superior to the interests of other potential creditors. By **attaching and then perfecting the security interest**, the bank's claim to the collateral generally becomes enforceable against purchasers who might buy the collateral from the debtor, subsequent creditors who establish a security interest, or creditors who obtain a court judgment or lien against the property.

For example, if a bank has a perfected security interest in equipment and, a few months later, another creditor places a lien on the equipment for nonpayment of debt, then the bank's superior right to the collateral is maintained by virtue of perfection. If and when the equipment is sold, the bank is entitled to the proceeds of the sale in the amount of the unpaid balance remaining on the loan.

Depending on the collateral, under the UCC, perfection can be accomplished automatically by attachment, by taking possession of the collateral, by taking control of the collateral, or by filing a UCC-1 financing statement. A filed financing statement makes the security interest of the bank a matter of record. In general, the UCC perfection rules provide a means whereby third parties considering whether to obtain a security interest in the collateral can learn of an earlier security interest. Further, a third party can search for a security interest without asking the debtor. Most searches can be conducted electronically through the secretary of state's office of the state where the business is headquartered.

The type of collateral dictates the method of perfection. For accounts, inventory, fixtures and equipment, a business banker generally will file a UCC-1 financing statement. In many states, the financing statement for fixtures must include a description of the real estate and be filed where the real estate mortgage is recorded. Fixtures that are or become an essential part of the real property, such as elevators, are perfected through a mortgage or deed of trust.

To represent perfection, the UCC financing statement must contain the name and address of the debtor and the secured party (or the secured party's representative), and a description of the collateral. Most states now have electronic filing of financing statements. The information on the financing statement should correspond to similar information on other documentation, such as the promissory note and the security agreement. For example, using the Dry Supply case, a "Kaitlyn" Nieson on the promissory note should not be a "Katie" Nieson on the financing statement.

Once the financing statement is completed and signed, it is filed at the appropriate location for public records. Under the revised UCC Article 9, the location of filing for a business debtor is generally the state where the debtor is incorporated.

With some exceptions, a filed financing statement is effective for a period of five years from the date of filing. Revised UCC Article 9 contains several rules governing transition from old Article 9 to the revision, such as ones relating to the effect on prior perfected security interests. A loan officer can file Form UCC-3 for a continuance or change to the original filing. Once the loan is paid, the bank, within 60 days, must provide a termination statement releasing the bank's claim to the debtor's collateral. If overlooked, the bank may incur damages for noncompliance.

Attachment and perfection of a security interest

- Attachment
 - Having a written agreement stating the bank has a security interest in the property
 - The bank gives consideration
 - The borrower maintains rights in the collateral
- Perfection
 - Filing a financing statement
 - Physical possession or control of the collateral

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Priority of security interest

Although perfection of a security interest does not assure a priority claim over all third parties, it creates the opportunity for obtaining priority. The time to perfect and the method of perfection vary state by state, but the following are generally true:

- With the exception of a few clearly defined cases, conflicting security interests rank according to their date and time of filing. Bankers talk about being “first to file.” In other words, if a security interest is perfected on January 1, and it is followed one month later by filings of other creditors, then any claims of the first creditor will be enforced before those of other perfected secured creditors or unsecured creditors
- There are instances when a later filing can take precedence over the security interests of earlier creditors. One exception is when a **purchase money security interest (PMSI)** is perfected, which is done by making a clear indication on the UCC-1 financing statement and following other procedures. A financial institution might desire to take a purchase money security interest when the borrower is using the loan proceeds to purchase the security used as collateral
- Actual possession for perfection—If perfection of a security interest depends on possession of the collateral by a secured party, perfection occurs no earlier than the time the secured party takes possession and continues only while the secured party retains possession
- Control for perfection—A security interest in investment property is perfected by control from the time the secured party enters into a control agreement with the holder of the investment property, and takes priority over a security interest in investment property perfected by a UCC filing

More on purchase money security interests

A purchase money security interest (PMSI) is a security interest only in goods or software that is collateral for a debt that has arisen with the sale of the goods or software to the debtor. Goods includes inventory, one of the more common types of collateral involved in commercial lending. A PMSI gives the seller of merchandise (that becomes inventory) on credit a priority over other creditors who may also have a security interest in the inventory. If certain steps are followed, the seller can attain priority over a bank that may have a perfected, “blanket” security interest in any after-acquired inventory. The seller’s priority interest in the specific inventory extends to certain identifiable cash proceeds.