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About the BusinessAdvisor

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LIENS, LOANS, AND COLLATERAL

by Mary Hanson

In today's economic environment, every business person needs to know more about loans, liens, security agreements, and other obligations related to loans.

Most business owners are aware of the use of liens on business equipment or personal property to secure loans. Now it is more important than ever to know how commercial liens work, in order to avoid problems, misunderstandings, and even financial loss due to a lack of knowledge about liens and loans.

In the current environment there is much for both borrowers and lenders to be nervous about. There is:

- greater risk of non-payment;
- greater risk of inadequate collateral value to cover the loan amount;
- greater risk of other creditors who may claim rights to the same assets;
- greater risk of a borrower facing bankruptcy or foreclosure on the assets, both of which set the stage for a conflict between or among conflicting creditors.

This article refers to commercial loans, not consumer loans, and some of the basic rules of California law. Each state's laws are different and there are laws that specifically address consumer loans, intending to protect consumers. Consumer loans are loans that are intended by the borrower for use primarily for personal, family, or household purposes, whether secured or unsecured. Under California law the definition, and the protective provisions of the Financial Code regarding consumer loans, also apply to business loans for less than $5,000 that are secured by business income of the borrower. This article is general in nature and is no substitute for legal advice regarding loans. This article is intended to alert business owners to the complexities in the laws regarding loans and liens.

The Three Basic Features of a Good Lien

Here are the most basic things you need to remember about loans when you are doing ANYTHING that involves a loan or MIGHT involve a loan (of yours, of a customer, or of a party selling you equipment or other assets).

The structure of a loan based on collateral consists of three parts. The first part is the underlying obligation (e.g., the loan of money). The second part is a security agreement, which identifies the collateral and all the details about how the secured party (usually the lender) can get the collateral and how the borrower has to take care of the collateral. The third part is the filing with the Secretary of State or other office in order to get that lien in place on the collateral ahead of other potential liens.

This is an important concept. A valid lien, with priority over other creditors requires:

1. An underlying obligation (a loan, a line of credit, or other commitment to pay) that remains unpaid;
2. A security agreement that identifies the collateral on which a lien is placed and that sets out the terms necessary to enable the

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"One of the huge mistakes made by amateur lenders is the failure to have a written security agreement that establishes the lender's right to the collateral."

lender to foreclose on the collateral; and

3. A filing with the correct agency to "perfect" the lien (such as a lien filing with DMV for vehicles or a UCC-1 filing with the Secretary of State for many types of assets).

Each of these parts is fraught with peril, making the secured loan one of those "do not try this at home" activities. An ineffective do-it-yourself loan and security agreement is very likely to expose the lender to non-payment of the obligation and the loss of the collateral. A lender making a loan based on collateral should be certain that the underlying obligation is written so that action can be taken to collect on the entire obligation if payments are not made, as well as ascertaining that the collateral has adequate value and that the lien is valid and has priority over all other liens on that collateral (or at least that the priority position is known and acceptable to the lender).

Even with all 3 parts addressed and professionally done, there is often still a possibility that some other lien is superior to yours, or that there are defects in your claim for payment, but without having the three parts, the effectiveness of the lien is severely impaired.

The Underlying Loan

If a loan has been repaid the creditor is required to release the lien. There can't be a valid claim to a lien (a "security interest") in an asset if there is no underlying obligation of the asset owner to the "secured party."

The easiest way to get rid of a lien is to pay off the underlying obligation. Of course, in today's environment, one is best advised to check on the loan, the lien, the creditor, and make sure the lien will be removed as anticipated.

The Security Agreement

One of the huge mistakes made by amateur lenders is the failure to have a written security agreement that establishes the lender's right to the collateral. To the average borrower, a security agreement is a long agreement with a lot of detail and legal mumbo-jumbo. To a lender, the security agreement is an essential document that covers a number of functions. Within the security agreement, the borrower typically waives a number of rights the borrower would otherwise have under laws regarding loans (such as notices), agrees to protect the asset (such as by insuring the asset), and agrees to do many things, including making the collateral available in the event of the borrower's default. The security agreement authorizes the secured party to do certain things in the event of default. The security agreement must identify all the assets securing the loan. Typical collateral includes furniture, fixtures, equipment, inventory, vehicles, accounts receivable, contracts, and even intangibles, such as trademarks.

Collateral can be almost any type of asset that has value. A good security agreement makes sure that methods of foreclosure are available as appropriate for the types of assets used to secure the underlying obligation. But it is important to understand that actual foreclosure can be a challenging and expensive proposition. And any lender planning to just "go in and take the equipment" faces possible loss of rights on repayment and possible liability to the borrower.

A lender making a loan based on particular assets, and fully intending to foreclose and take the assets in the event of default, needs to consult with an attorney experienced in foreclosures before the security

agreement is completed. The potential foreclosure steps and the associated costs must be understood before such a loan is made. The security agreement must adequately address the rights a lender needs to gain the benefit of the collateral in the event of default.

The security agreement is the glue that ties the financing statement filed with the Secretary of State (if the UCC-1 filing is the appropriate filing) to the underlying loan. It is the high-calorie filling in the middle needed to complete the three part Oreo cookie.

Perfection

"Perfection" – often called "filing" (because the most familiar perfection is the filing of a Financing Statement (UCC-1) with the Secretary of State). In fact, the proper filing depends on the nature of the asset. The common types of perfection in addition to the filing of a UCC-1 with the Secretary of State include the filing of a lien on a vehicle at the DMV (Department of Motor Vehicles) and the taking of possession by the lender (for pledges of corporate stock, and some other similar types of assets).

This part of the lending process is trickier than it seems. An adequate description of the collateral in the UCC-1 or in other filings is essential to have a valid lien. The filing must be in the correct place for the type of asset and location of the asset. The filing is not permanently effective and must be refiled before the expiration of 5 years to keep it valid.

If the filing to perfect the lien is not done, or is ineffective, it doesn't mean that there is no loan or no lien. It only means that another lender with a valid lien on the property will have priority over the ineffective or non-existent lien. And in the event of the borrower's bankruptcy, the debt will be treated as a general unsecured debt with all the other general unsecured debts of the debtor.

There are a few exceptions under the law (such as the exception that allows a piece of equipment to be purchased with a lien – on the purchased equipment – that has priority over a prior lien on "all assets.") Exceptions and overlapping rules make this a tricky area of law.

Do's and Don't's Regarding Liens

Here are some bits of advice regarding liens:

- If you are purchasing a piece of equipment or any assets from another business, you must check to see that there are no liens on it. If you purchase an asset with a lien on it, you will have to pay off the lien in order to keep the equipment (even though that may be a double payment).
- If you have a lien on any of your business assets, you can't "upgrade" them by selling those assets and buying replacement assets, unless you are working with your lien-holder to do so. Any sale of properly liened assets without the lender's involvement is normally a violation of the terms of the security agreement. Such a default can trigger acceleration of the obligation and other consequences. And the "upgraded" equipment probably still has a lien on it because of the language of the security agreement.
- If you wish to sell equipment that has a lien on it you need to obtain a release from the lien-holder. Historically, creditors required a payoff in full for release of the lien. In today's environment, creditors may be more flexible – and may

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Publisher's Note

In today's economic environment, lending is more costly to lenders. In addition to the greater risk of non-payment and inadequate collateral value, the cost of collection can be higher, and it may be more difficult to get the value out of the collateral by selling it at a good price. The potential for numerous competing creditors may be greater.

In the past, lenders could be somewhat confident that in the unlikely event that a loan was not paid, the lender could threaten foreclosure and get paid. In the current economy, any such confidence is misplaced. Lenders need to understand, in advance of making any loan, that liens and foreclosure are generally complex and are not appropriate subjects for do-it-yourself legal work.

Banks and asset-based lenders have years of experience in making collateralized loans. They have the appropriate staff and professional relationships to take appropriate action in the event of default. Business owners need to know the basics regarding collateralized loans, but are best advised to make such loans only with extreme caution and an appropriate budget.

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be willing to allow the transfer of the lien with the transfer of the equipment if the buyer is credit-worthy and willing to assume the payments.

- When making a loan to an entity (a corporation, an LLC, a limited partnership, etc.), get personal guarantees from the individuals behind the entity.
- When making a loan to an individual, get the consent of the individual's spouse, even if the spouse is not involved in the business.
- Don't provide a personal guaranty on a loan unless you absolutely have to and it's for your own benefit. Treat a guaranty as if it is a direct personal obligation.
- When making a loan based on a lien on a particular asset, make sure the asset has value and does not have prior liens already filed on it.

This area of law is very rule based. When there is a conflict between creditors (in litigation or in a borrower's bankruptcy) many legal rights and facts are argued. Was the filing exactly in accordance with the laws of the state where the property is located? Was the property adequately described? Was the debtor adequately identified? Was the timing correct so that the other creditors are in second place and did not get to be first in line?

Upon default and the taking of the asset by a creditor, many more rules come into play. Requirements include notices, waivers of the debtor's rights, and proper use or sale of the asset. Were the debtor's rights violated in the repossession of the asset, the sale of the asset, or some other action? BA

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