

The collateral conundrum

by David W. Morse

With many companies moving from unsecured credit facilities to secured facilities, whether with a true asset-based structure or simply just adding collateral and with companies exchanging unsecured debt for secured debt, whether first lien or second lien or 'split' or 'bifurcated' or 'mixed' (that is where each tranche of debt receives the benefit of a first lien on some assets and a second lien on other assets), setting out the 'right' description of the collateral is an issue lenders need to understand. It is critical that lenders negotiating for the secured facility understand the consequences of decisions to limit the scope of the security received.

To get the right collateral in the United States, the starting place is the Uniform Commercial Code, the legal foundation of secured lending in the United States. The 'UCC' includes a number of defined terms for different types of personal property assets that a company may have. At least in theory, the defined terms in the UCC are intended to cover the entire universe of possibilities for all personal property (since the UCC does not apply to real estate).

In putting together an engagement letter, proposal letter, term sheet or commitment letter, it is good practice to use these defined terms in describing the collateral that the arranger or lender will require as part of its credit facility.

Getting the right description of the security to reflect the lender's expectations arises in two particular contexts. First, the lender and the company will need to agree to the scope of the security to be provided to the lender. Second, when there are multiple tranches of debt secured by first liens on different categories of property, it becomes necessary to allocate the assets between the two tranches.

While often a company will expect that the lenders require a security interest in all of its assets, from time to time, a company will take the position that it is only going to grant to the lenders a security interest in certain types of property. For example, a retail borrower might start with the position that the lenders should only have a security interest in its inventory. Or, companies may want to limit the security interest to only 'accounts' and 'inventory'.

Limiting the scope of the lender's security does not offer any advantage or benefit to the company since the mere existence of a security interest does not have any impact on a company's operations or ability to pursue its business plan. In the occasional case where a company is concerned about the ability to sell a particular asset at some point in the future or obtain additional loans pursuant to a separate financing of a specific asset, the lender would simply allow for such events in the applicable covenants in the loan documents.

By contrast, limiting the scope of the lender's security can lead to unexpected adverse consequences to the lender. Without a security interest in the deposit account into which proceeds of receivables are deposited, the secured lender is at risk as to those proceeds. Or what if the proceeds are used to purchase certificates of deposit? Should the lender be entitled to such instruments as part of its collateral? What about the software used by the company that tracks the accounts receivable? Or if the account receivable owing to the borrower by a troubled customer is turned into a promissory note? In the case of inventory, a company might have warranty claims against the supplier of the inventory to the company. Should the lender that is relying on the inventory receive the benefit of any such claims? Damage claims against a carrier? What about the bills of lading covering inventory that is in transit? These are just a few examples. Simply obtaining a security interest in 'accounts' and 'inventory' would not lead to the lender being entitled to any of such items since the related assets described above are different categories of assets under the UCC. The description of the collateral in the lender's security agreement must refer to the UCC defined terms that apply to such assets if the lender is to get what it expects. In particular, the

UCC category of 'general intangibles' can be critical, since it includes intellectual property that may be affixed to inventory as well as claims that may arise related to such underlying assets as accounts and inventory.

The failure to include assets in the collateral may lead to a problem when a business is sold as a going concern in an asset sale. The question will arise as to what portion of the proceeds from the sale may be attributable to the assets subject to the security interest of the lender and what portion of the proceeds are not and therefore are available to other creditors and shareholders. In a recent bankruptcy case, the creditors' committee argued that because the secured lender did not have a perfected security interest in certain leaseholds of a restaurant chain, the secured lender was not entitled to some portion of the 'goodwill' tied to the enterprise value of the Chapter 11 debtor attributable to such locations.

Another recent case illustrates the issue in the simple context of a sale of a motor vehicle. A bank made a loan to an auto dealer secured by the dealership's inventory. After the company filed for Chapter 11 under the US Bankruptcy Code, the vehicles were sold. As part of the sale of a vehicle, the dealer also sold an extended warranty to the purchaser, as well as receiving a fee for arranging for third party financing of the purchaser and receiving incentive payments from the vehicle manufacturer. Because the bank's security interest was limited to the vehicles, the court concluded that it did not receive any of these additional amounts.

In the case where certain assets such as equipment and real property are to be subject to the first liens of one group of lenders while the accounts and inventory are to be subject to the first liens of a different group of lenders, the same issues of properly describing the collateral emerge. While it is easy to only refer to equipment and real estate versus accounts and inventory, the use of just these categories is not sufficient to capture the parties' expectations, since assets related to each category will require additional UCC terms be added to the description of the collateral.

The scope of the security for the lender moving to a secured credit facility or exchanging its debt for secured debt should be addressed at the outset of the structuring of the facility so as to be certain to include the related assets as well.

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