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Some Terminology to help you in Commercial Transactions I – 101A, September 17, 2003

Security Interest—generally, a limited interest in personal property created by a debtor in favor of a secured party to secure repayment of a debt or performance of an obligation. *Read* the defined term at UCC Section 1-201(35). Professor Widen may yell at you if you forget that the defined term includes interests in fixtures, the interest of a consignor, the interest of a buyer of accounts, chattel paper, payment intangibles or a promissory note, etc. In general, a security interest is to personal property what a mortgage is to real estate. **HOWEVER, DO NOT LET THE COMMON UNDERSTANDING CAUSE YOU TO FORGET THE TECHNICAL USE OF THE TERM!**

Limited Interest—basically, any interest in a property object that is not exclusive. A security interest is a limited interest in the hands of a creditor because the creditor does not have the exclusive right to use, consume, enjoy or transfer the property object that constitutes the collateral. The creditor only can do these things upon the occurrence of a condition subsequent (typically called an “Event of Default,” –e.g. the failure of the debtor to pay or perform the obligation secured or comply with a covenant). The creditor exercises remedies to enforce its security interest when the condition subsequent occurs. The UCC contains rules governing the enforcement of security interests. **NB:** the security interest acquired by a buyer of accounts, etc., is NOT a limited interest if the transaction is a bona fide sale transaction.

Financing Statement—this is a special form known as a UCC-1 (typically a piece of paper and, now, increasingly, filled out and submitted electronically). You may see a sample financing statement at Section 9-521(a). In general, if (i) a debtor authorizes the filing of a financing statement, (ii) the financing statement is properly completed and (iii) the financing statement is filed in the appropriate location, the filing of the financing statement is the completion of the ceremony that perfects a security interest. (DO NOT FORGET THE FILING FEE!) (NB: financing statements do not work to perfect a security interest for every kind of personal property covered by the UCC. Learn your exceptions!) Under Revised Article 9 a debtor need not sign a financing statement but the debtor must authorize the filing of the financing statement in a formal way. Look at Section 9-509.

In practice you must be careful about the form of financing statement used. Most states will accept the version known as the “National Form.” States may adopt the National Form or supplement use of this form with state approved forms, such as the forms approved in Florida. It is essential to look at any special state approved form to make sure you do not overlook non-standard amendments to the UCC for particular asset classes or debtors (e.g. New York and co-ops use a special addendum to the UCC-1). To do an actual deal you **MUST** go to an official website or other source to find out the current approved form or forms for filing and the applicable filing fees (they differ by state). Assume nothing. Even if a form worked in a prior deal the approved forms may have changed. In addition to the financing statement, there are forms of addendum and amendment. The addendum is used for special types of collateral and debtors. The

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amendment form can be used to terminate, continue, assign or amend a financing statement. A financing statement is NOT a security agreement. Go to the Helpful Links page of the UCCstuff website and view financing statement forms and commentary by clicking links for Delaware, Florida and New York. The New York Department of State and Delaware Secretary of State pages contain links to particularly good explanations of the applicable search logic and what it means to use the debtor's exact name. For example, go to the Delaware Secretary of State page, find the UCC administrative rules and read them, particularly Section 2 and Section 3. READ THESE LINKS. Compare the New York and Delaware filing offices with the Florida filing office. What is the difference?

Security Agreement—this is the agreement between a debtor and a secured party in which a debtor creates a security interest in one or more of its property objects for the secured party. Section 9-102(73). The property objects in which the security interest is created are known as “**collateral**.” (NB: Even a buyer of accounts has “collateral” in the defined sense of the word.) A security agreement does not always need to be in writing (there are exceptions for certain asset classes), though it usually takes written form. If the security agreement is in writing, the security agreement needs to be signed¹ by the debtor but not the secured party (though the secured party usually signs it). It may be important for the secured party to sign the security agreement for business reasons not directly related to the technical requirements of the UCC. A sample security agreement appears at page 19 of the Text and another more general version of a security agreement (annotated for revised Article 9) appears on the UCCstuff website on the Precedent File page (the green briefcase icon). Keep in mind that the UCC defines both “agreement” and “contract.”

Collateral—basically, the property objects of a debtor that the secured party gets to take away if the debtor fails to pay a debt or perform an obligation. It includes more. Section 9-102(12).

Automatic Stay—this is the part of the Federal Bankruptcy Code that stops a creditor, at least temporarily, from taking away the Debtor's stuff. You can find it at Section 362 of the Bankruptcy Code. Once a debtor files for bankruptcy protection, the automatic stay stops all enforcement efforts by the creditor to collect on the collateral by enforcing the security interest. As a general rule, however, the automatic stay does not change the ultimate priority ordering given to a secured creditor by the security interest. A creditor may petition the bankruptcy court to lift the stay so the creditor may proceed against the collateral.

¹ I am, of course, speaking loosely here. The UCC defines both “signed” (Section 1-201(37)) and “writing” (Section 1-201(43)). As a hyper technical legal matter, my statement that a debtor must *sign* a security agreement is misstated. The debtor “authenticates” a security agreement under Section 9-203(b)(3). In turn, “authenticate” is a defined term that includes the act of signing, but is broader to include various actions taken in the electronic world. Section 9-102(7). This definition should be read in conjunction with the definition of “record.” Section 9-102(69). This footnote should indicate to you why this outline is a SUMMARY ONLY. You **must** work through the definitions for every term. Consider this outline “Commercial Law for Poets.” My aim is to transform your understanding from this broad outline into “Commercial Law for Lawyers.”

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Future Advance—think about a future advance in terms of a timeline. At T1 the debtor grants a security interest to the creditor and the creditor loans the debtor \$100. Later, at T2, the creditor loans the debtor an additional \$50. This additional \$50 is known as a “future advance.” The question often arises whether or not the future advance at T2 has the benefit of the security interest created at T1. The wording of your definition of secured obligations, together with case law creating presumptions for certain asset types, will determine whether or not a future advance is secured. The UCC contains a specific section that speaks about future advances. Section 9-204.

After Acquired Property—think about after acquired property in terms of a timeline. At T1 the debtor owns a definite number of property objects. Suppose that, at T1, the debtor grants a security interest to a secured party that covers *all* of these definite number of property objects. Later, at T2, the debtor acquires new property objects. These additional property objects are known as “after acquired property.” The question is whether these new property objects acquired at T2 constitute collateral under the security interest created at T1. (Did *all* mean “all, including the future” or just “all existing at T1?”) A clause in a security agreement that purports to include after acquired property is known as an “after acquired property” clause or an “after acquired collateral” clause. Its wording determines, in part, the scope of the security interest that is created. The UCC contains a specific section that speaks about after acquired property. See Section 9-204.

Collateral Description—just what you would think, namely, a description of the collateral. The tricky part is that you must ask: for what purpose a particular collateral description is used and where does it appear? Typically, a collateral description will appear in two places: in a **financing statement**² and in the **granting clause** to a security agreement. You must be careful because the UCC requires a different level of detail for the description of collateral used in a financing statement and a description of collateral used in the granting clause of a security agreement. Make sure you learn the difference! (Hint: “description” of collateral is used in Section 9-203(b)(3)(A) and “indication” of collateral is used in Section 9-504.)

Great Unwashed, The—a slang term for any unsecured creditor or for unsecured creditors as a group.

Strong Arm Power—this refers to the power of a bankruptcy trustee to take away security interests from unsecured creditors if the security interest is not perfected at the time of the bankruptcy filing by the debtor. You can find it in Section 544 of the Federal Bankruptcy Code. The bankruptcy trustee has the status of a hypothetical lien creditor who acquired its lien on the date of the filing of the bankruptcy petition. Read Section 9-317(a)(2). Who beats an unperfected security interest? You got it—among others, a lien

² For financing statements, take a look at Section 9-502(a)(3). Notice that the UCC does not say the financing statement must include a *description* of the collateral. Instead, it says “indicates” the collateral. The phrase “description of the collateral” appears in Section 9-203(b)(3)(A). You guessed right if you think there is a difference. Try to figure it out! This is just another example of the problem with a plain English summary.

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creditor that obtains a lien before a security interest is perfected. NB: A big exception to this is contained in Section 9-317(e) for **purchaser money security interests** (Section 9-103) also known as “**PMSIs**.” See also, Section 9-323(b) for other rights of lien creditors under the UCC.

Preference—this is shorthand for a transfer of an interest in property that occurs shortly before the filing of a bankruptcy petition by a debtor in respect of “antecedent debt.” A transfer of a limited interest in property, such as a security interest, is a transfer within the meaning of the Bankruptcy Code. Again, think of a timeline. At T1 creditor loans debtor \$100 but does not take a security interest. At T2, shortly before debtor files for bankruptcy, creditor gets nervous and demands that debtor grant a security interest to secure the repayment of the \$100. This grant of a security interest at T2 is a transfer of property in respect of the antecedent debt incurred at T1. If the transfer at T2 occurs within the period of 90 days prior to the bankruptcy filing (one year in the case of a transfer to an insider), then it will be a preference under Section 547 of the Federal Bankruptcy Code. The trustee might avoid the transfer if the creditor does not have an available defense.

Fraudulent Conveyance—basically, this is a transfer by a debtor of an interest in property (including the transfer of a security interest) either (i) with the intent to hinder, delay or defraud a creditor (actual fraud) or (ii) for insufficient value at a time when the debtor is insolvent (constructive fraud). This is bad. A trustee in bankruptcy can recover a fraudulent transfer from the recipient of the transfer for the benefit of creditors of the bankrupt debtor either under Federal Bankruptcy law directly (by using Section 548) or indirectly using state fraudulent transfer law in combination with the Strong Arm Power (Section 544). Under Federal law the statute of limitations is one year and under state law the limitation period varies (generally 4 to 6 years). The trustee uses state law when the Federal period has expired. Notice that these statutes generally permit a trustee both to recover transfers *and* to take away the benefit of obligations incurred by a debtor for the benefit of an obligee. A fraudulent conveyance is sometimes referred to as a “fraudulent transfer.” See, for example, the terminology under Florida law and the Federal Bankruptcy Code.

Subordination—basically, creditor A is subordinated to creditor B if creditor B gets paid before creditor A. Typically, subordination is conceptualized by reference to the claim, rather than the creditor itself. Thus, creditor A’s *claim* would be subordinated to creditor B’s *claim*. The use of a perfected security interest has the effect of subordinating one creditor or a whole class of creditors (such as the Great Unwashed) to the secured creditor. Subordination, however, might occur as a matter of pure contract using a device known as a “**subordination agreement**.” A subordination agreement might be used by unsecured creditors or by secured creditors. A subordination agreement is NOT a security agreement. However, if multiple creditors share the same security interest, the multiple creditors might contract among themselves to create a priority ordering in which it is agreed that creditor B gets the first proceeds from the collateral until creditor B is paid in full and then creditor A gets the remaining proceeds, if any. In such a case, if creditor B is not paid in full, then creditor A gets nothing even though it benefited from

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the security interest (i.e. was a secured creditor with respect to the collateral). Sample language from a subordination contract appears on the UCCstuff website in the Precedent File as “Subordination Article.”

Equitable Subordination—basically, equitable subordination achieves the same result as a subordination agreement. However, the basis for the subordination is not contract but is court imposed. If creditor B complains to the bankruptcy court that creditor A was bad, the bankruptcy court might decide to use its equity powers and subordinate the claim of creditor A to the claim of creditor B to achieve an equitable or just result. This might happen whether or not the claims are secured claims. Often, the claims are unsecured.

Substantive Consolidation—basically, an equitable doctrine that allows a bankruptcy court to treat two separate legal entities as a single entity. Most often justified if the companies keep sloppy books and records, ignore formalities and creditors have treated the companies as a single unit. (Think about “piercing the corporate veil” and the “alter ego” doctrine if you have taken a business associations class for an analogy.) By squeezing two companies together, the assets of the two entities are combined into a single pool from which to satisfy creditors and the inter-company liabilities are eliminated. Not a happy situation if you are an unsecured creditor relying on separate corporate form to achieve priority.

Perfection—basically, a form of Article 9 Nirvana. But don’t get too excited. A perfected security interest should defeat the interest of a judicial lien creditor. See Section 9-317(a). You might think, therefore, that a perfected security interest should be “**bomb proof**” because a Bankruptcy trustee using its status as a hypothetical lien creditor under the Strong Arm Power may not defeat it. However, a perfected security interest is far from “bomb proof.” Even though perfected, a security interest might be either a preference or a fraudulent conveyance. Further, even if a security interest is perfected that does not mean that another security interest or other privileged party does not have priority. Priority will depend upon a variety of factors, including the timing of filing or perfection, the nature of the security interest, the method used to perfect and the nature of other parties claiming an interest in the collateral.

Granting Clause—the operative or performative language in a security agreement that creates or provides for the security interest. “The Debtor hereby grants, creates, transfers, etc., a security interest in the Collateral to the Secured Party to secure repayment of the Secured Obligations.”

Negative Pledge—a slang term for a covenant that says “Creditor A covenants and agrees that it will not create [or suffer to exist] a lien or security interest on its property.” There are many flavors of the negative pledge. Some simply apply to restrict debtor action on a going forward basis, others require the debtor to clean up pre-existing liens and/or involuntary liens that arise on its property in the future. (Think about judgment liens and liens for taxes, mechanics liens, etc.) There is a BIG difference between “create” and “suffer to exist” as a contract drafting matter.

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Bomb proof—just what you would expect.

Hong Kong Cavaliers—the rock band run by Buckaroo Bonzai. Perfect Tommy is a member of this band.

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