



Mary Hanson

About the Business Advisor

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LOANS, LIENS, AND COLLATERAL: What Lenders and Borrowers Should Know

by Mary Hanson

Business owners, lenders, and borrowers should know the basics of loans and liens. American homeowners, consumers, and businesses commonly use assets as collateral to secure obligations to repay loans or pay for goods. Mortgages, car loans, business equipment loans, bank lines of credit, solar panel programs, and SBA loans are familiar methods of borrowing based on assets. However, many participants in the transactions (lenders, borrowers, business owners, equipment buyers, etc.) could use a better understanding of the basic features of loans secured by assets.

Every state has laws related to loans and liens. Consumer loans, primarily loans for purchases for personal, family, or household purposes, are subject to laws intended to protect consumers. Laws covering asset-based lending relating to commercial activity are not consumer-protection laws, but are commercial laws which set out rights, duties, responsibilities, and remedies related to commercial transactions. Commercial laws are intended to facilitate lending by protecting both lenders and borrowers from harmful practices.

Here are a few of the things that should be understood by those who use loans based on collateral:

- Loans secured by assets are called “secured loans.” The term “unsecured loan” refers to a loan or credit extension like a bank credit card that is not based on collateral.
- Secured loans typically carry lower interest rates than unsecured loans and require lower borrower credit scores,

since the assets used as collateral provide lenders some protection against nonpayment.

- Secured loans require a great deal more “paperwork” than unsecured loans, based on the type of asset used to secure the loan, the laws relating to lending based on that type of asset, and the concerns of lenders relating to the risks involved in maintenance of that type of asset and the method of foreclosure on that type of asset.
- Assets that are commonly used as collateral include cars, trucks, houses, stocks and bonds, commercial buildings, business equipment, inventory, and accounts receivable. There are many other types of property that can be used as collateral, including legal instruments, intellectual property like trademarks and patents, and other intangible property.
- Terms used to describe lending based on security interests in assets differ significantly for different assets and from industry to industry. The security interest (or the process of getting a security interest) may be called a “lien,” “mortgage,” “hypothecation,” “collateral,” “margin,” or “pledge.”
- Borrowers are most familiar with mortgages on residential property. The concept – a loan based upon the lender’s ability to foreclose and take the asset – is essentially the same for all secured loans. However, the details of the steps to be taken will be very different for every type of asset.
- Commercial lending laws are very similar from state to state because many states adopted most of the standard

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commercial law provisions of the Uniform Commercial Code (“UCC”). Nevertheless, important particular details can vary greatly.

- Lenders need to have agreements with borrowers to establish lenders’ interests in the assets used as collateral. The documents may be mortgage agreements, security agreements, collateral agreements, pledge agreements, margin agreements, or some other agreement based on the industry and type of collateral.
- The benefits to lenders of having collateral include greater likelihood of on-time payments, greater likelihood that the entire loan will be paid, the right to foreclose on the collateral in the event of non-payment, and priority (in getting paid) over unsecured lenders in the event of a borrower’s bankruptcy.
- Professional lenders want their security agreements to comply with the legal requirements so that they maintain the right to foreclose on collateral.
- Professional lenders want to follow the legal requirements that give them priority over other obligations of borrowers in the event of bankruptcy, including filing documents in the correct state with the correct agency for the particular type of collateral.
- As a general rule, mortgage lenders are prepared to foreclose on real property, vehicle lenders are prepared to repossess vehicles, equipment lenders are prepared to foreclose on equipment, etc.

The Three Basic Requirements for Effective Liens

A valid and fully enforceable security interest (including priority over other

lenders) in an asset requires three components:

1. An underlying obligation (a loan, a line of credit, or other commitment to pay) that remains unpaid;
2. An agreement that identifies the collateral and sets out the terms of the security interest that enables the lender to foreclose on the collateral; and
3. Steps defined by law that “perfect” the security interest, such as by recording a lien on real property with the County Recorder or Registrar of Deeds, by adding the lender as “lienholder” on a vehicle Certificate of Title from the DMV, or filing a Financing Statement (a “UCC-1”) with the Secretary of State for a security interest in personal property.

The Underlying Obligation

The underlying obligation may be represented by a promissory note or some other contractual obligation to repay a lender. The obligation could result from funds advanced to the borrower or from the borrower’s purchase of a product using funds advanced to the seller of the product.

If a loan has been repaid – or never made – the creditor is legally obligated to release the lien. No valid claim to collateral can be made when there is no underlying obligation of the asset owner to the secured party.

The Security Agreement

The agreement that establishes the lender’s right to the collateral usually performs a number of functions. In a typical agreement, depending on the nature of the collateral, a borrower agrees to keep the collateral in good condition, keep it insured, keep it in the same location under the borrower’s

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control, and make it available to the lender in the event of the borrower's default. The borrower typically waives a number of rights the borrower would otherwise have under applicable law (such as the right to notices from the lender regarding the borrower's default). The agreement authorizes the secured party to take action against the borrower and take action related to the collateral in the event of default. The agreement is typically a robust agreement covering a number of duties, rights, and remedies for a variety of circumstances that could arise involving the particular type of asset used as collateral.

Perfection

The filing of a Financing Statement with the Secretary of State, the recording of an interest in real property with the Recorder of Deeds, and the lienholder designation on a Certificate of Title issued by the Department of Motor Vehicles are the most common steps for "perfecting" security interests. There are many different legal requirements for "perfection" because there are many other types of assets (other than personal property, real property, and motor vehicles) that are used as collateral and require a different action for "perfection." In California perfection for security interests in promissory notes and shares of stock used to require the secured party to actually take possession of the collateral. Possession may still be required for perfection of security interests in some types of collateral in some states.

Perfection of the security interest is necessary for a lender to have priority over other creditors of a borrower in the event of a bankruptcy or a dispute over rights to collateral.

In California filing a Financing Statement (UCC-1) with the Secretary

of State perfects a security interest in personal property such as business equipment. The filing of a UCC-1 showing an individual or business entity as a debtor and identifying assets subject to the security interest also serves a valuable purpose in making interested buyers aware of existing liens. The Secretary of State's UCC database is available to the public at <https://bizfileonline.sos.ca.gov/search/ucc>. A lender, buyer of equipment, or a party interested in buying the assets of a business can see the financing statements (and also involuntary liens) recorded against the assets of a particular business. In addition to being able to search the on-line database, a potential buyer or other party can obtain a lien search report certified by the Secretary of State.

A potential buyer of equipment or other lien assets can require release of the lien by the secured lender in order to purchase the assets. The recorded financing statement makes it less likely that a debtor could sell lien assets "out from under the lien," sell the business without the knowledge of the lender, or inadvertently sell lien assets without paying off the lender.

The ability of a lender to see a borrower's commitments to other lenders and to impede improper transfers of collateral provides a lender with some comfort and control in addition to the assurance of a priority position in the event of a borrower's bankruptcy.

The filing of a UCC-1 must correctly identify the parties (debtor and secured party), adequately describe or identify the (personal property) collateral, be filed in the right place (the correct jurisdiction), and be timely filed (ahead of other creditors or within a deadline for filing). There are just a few situations in which a later lender can

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Publisher's Note

The use of "security interests" to assure payment of obligations goes back hundreds of years. In medieval times collateral could be a person – typically a young relative of the debtor – placed under the control of the lender until the debt was resolved. That simple but effective approach has been replaced over the centuries by various laws affecting lenders, consumers, and businesses.

In the U.S. the Uniform Commercial Code which sets out detailed rights, duties, and remedies for a broad range of commercial transactions and secured transactions is a good example of the "rule of law" supporting a stable economy. Having stated laws that cover an important part of commerce, along with a legal system that understands the laws and is capable of providing justice, supports the U.S. economy by facilitating economic activity.

The "Rule of Law" refers to having laws, institutions, and practices that provide accountability in personal rights, contracts, and property, so that a country with a strong "rule of law" enjoys stability and economic growth based on individuals' confidence in pursuit of business and financial objectives.

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get ahead of existing lenders by qualifying for special priority treatment. Security interests in other types of collateral also require compliance with the applicable steps, whether recording, taking possession, or filing documents with specified agencies in the appropriate jurisdiction.

A lender who has failed to perfect a security interest properly in the correct jurisdiction may face serious disappointment in the event of a borrower's bankruptcy. Instead of a priority position as a secured lender with a security interest in collateral, the lender's position may be that of an unsecured creditor, and other creditors of the borrower may be paid ahead of the lender.

Advice for Lenders

None of the steps described in this article are suitable as a "do-it-yourself"

project for a lender. Even business attorneys would be well-advised to use an experienced attorney or firm to handle the legal work for a secured loan of any significance. The nightmare scenario of a lender's dropping from a preferred position in a bankruptcy to being an unsecured creditor with little prospect of repayment is not far-fetched if a situation involves unusual collateral, multiple jurisdictions, or competing creditors.

Taking a security interest in an asset – and doing so promptly – is highly recommended for any lender of any loan. A good security interest in collateral greatly increases the likelihood that the borrower will repay the loan – either in accordance with the loan terms or at a point where the borrower wishes to sell or transfer the lien asset.

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