

C o r p o r a t e L a w

A L E R T

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PROTECTING YOURSELF AS A SECURED CREDITOR

The faltering economy has caused, and will continue to cause, financial distress to businesses in all sectors. We have observed that many businesses do not take advantage of the extra protection offered by a relatively simple procedure under the Uniform Commercial Code (“UCC”), whereby lenders, suppliers of goods and services and consignors of goods can establish a security interest in the assets of a debtor. Such security secures payment by, or performance of an obligation of, the debtor. Collateral includes personal property and fixtures. It can include assets such as inventory and their proceeds, such as accounts receivable.

A security interest in any or all of a debtor’s property provides the creditor an added level of protection if the debtor is later unwilling or unable to repay the creditor. Having a position as a secured creditor can be crucial in the event of a debtor’s financial distress, insolvency or bankruptcy.

This Alert discusses how creditors can better protect themselves by obtaining a security interest in the assets of their debtors. It is a simple and inexpensive procedure with major potential.

Obtaining a Security Interest

To obtain a security interest:

1. The debtor must execute a security agreement in favor of the creditor. It can be a separate agreement between the parties or a section or provision contained in a broader document governing the creditor-debtor relationship, such as Terms and Conditions of Sale.
2. A security interest exists, and “attaches” to the collateral, as soon as the Security Agreement is executed, value is given, and the debtor has rights in the collateral.

3. The creditor must complete and file a UCC-1 Financing Statement with the Secretary of State in the state where the debtor is incorporated or organized and in the case of an individual, where the principal residence of the debtor is located. Among other things, the UCC-1 describes the collateral and establishes the creditor’s priority in such collateral against other creditors. The filing of the UCC-1 “perfects” the security interest against all subsequent filers and should be done as soon as possible after the Security Agreement is signed. In the case of a “purchase money security interest” (“PMSI”) (discussed below), filing should occur before goods are shipped or delivered.

The Mechanics

1. Before filing a UCC-1, a creditor should perform a search to determine if other creditors have already perfected security interests against the debtor’s property. Even if a previous creditor has already filed a UCC-1 against the debtor’s property, a subsequent creditor should still file a UCC-1 to protect its interests. Nonetheless, earlier filers will have priority and will be paid first should the debtor become insolvent.

However, suppliers of goods or property may be able to obtain a PMSI and go to the head of the line, ahead of prior filers, with respect to collateral (and its proceeds) supplied by them. In this case, a search is essential because of the prior notices required as discussed below.

2. A completed UCC-1 form is then filed as described above, with all necessary filing fees. Filing fees are relatively reasonable. For example, in New York, the fee is \$40 for a paper and \$20 for an electronic filing. For an additional nominal fee, it is a good idea to request a confirmation copy of the filing, date-stamped to indicate its receipt and filing by the Secretary of State.

(continued from page 1)

3. UCC-1 financing statements are valid for up to five (5) years, but they may be renewed for an additional five years by filing a Continuation Statement before the end of the initial five-year period. Conversely, when the debtor repays its debt to the creditor, and the security agreement is terminated, the creditor should file a Termination Statement (UCC-3) to discharge the security interest. Both of these forms are filed in the same manner and in the same jurisdiction as the original UCC-1.

Purchase Money Security Interest

A purchase money security interest is available to a creditor who supplies goods or property to the debtor. The primary difference between a PMSI and an ordinary security interest is that a PMSI can only secure an interest in property that the creditor sells to the debtor or delivers to the debtor on consignment.

However, an enormous advantage to a PMSI is that it is given priority over previous filings. Because the debtor would not have been able to acquire the property that is the subject of the PMSI without the creditor's assistance, the PMSI creditor is granted priority over all ordinary security interest holders with respect to the property supplied as well as to products and proceeds such as accounts receivable. It is rare that a business has no bank credit lines, financing or other secured debt, and thus, a PMSI can be a critical tool for eligible creditors.

To perfect a PMSI, two additional steps must be taken:

1. Creditors who hold conflicting interests must be notified in writing of the conflict, and that the PMSI creditor will file a UCC-1 Financing Statement to secure a PMSI debt; and

2. The UCC-1 Financing Statement must be filed before any goods are shipped or transferred to the debtor.

AN ESSENTIAL PROTECTION

Obtaining a security interest is an important step for any creditor to protect its rights in some or all of the debtor's property. As you can see from the foregoing, it is a relatively simple and inexpensive procedure. Yet, it can be of enormous importance in collecting debts from debtors in financial difficulty. In addition to achieving priority in the event of bankruptcy, a secured creditor may also have greater leverage in negotiating payment from a debtor experiencing financial difficulties.

Whether providing goods or services, financing or goods on consignment, every creditor should take advantage of this tool supplied by the UCC. It is impossible to predict who will have problems in the future and, therefore, we strongly advise that creditors adopt this procedure with all customers and clients.

While we counsel our clients to establish security interests as a matter of course, every creditor-debtor relationship is unique and solutions must be tailored to a client's individual circumstances. We stand prepared to counsel and assist our clients with all of their security interest needs and other creditors' remedies which may be available to them.◆

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This document is a basic summary of legal issues. It should not be relied upon as an authoritative statement of the law. You should obtain detailed legal advice before taking legal action.

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