

The Case Of The Disappearing Collateral!

Preparing For The Unexpected With Secured Loan Accommodations

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Executive Summary:

Lenders often take a security interest in a borrowing customer's accounts, inventory, equipment or other business assets to secure a loan. This collateral is intended to provide a secondary source of repayment in the event cash flow is insufficient to repay the loan. A common source of lender and borrower worry, however, is the occurrence of events that could diminish or wipe out the value of this collateral.

These worries are particularly acute when a key item of collateral is accounts receivable of a contractor, subcontractor or supplier to a construction project, growing crops are involved, or the lien at issue is a purchase money security interest.

The attached outline discusses taking and perfecting security interests and essential requirements of mechanics' liens, and then goes on to describe how the value of assets can evaporate if steps are not taken to ensure the borrower can fully enforce and protect its interest in these assets. These materials are appropriate for lenders who want to ensure that borrowers are protecting the value of collateral and, just as importantly, companies holding the assets and performing the work, who want to protect their own interests. The outline is intended to help in spotting potential issues. The authors are glad to elaborate on any of the points raised in the outline, and please contact them with any questions or comments you may have.

1. Introduction - Perfecting A Lien In A Borrower's Assets.

- a. Focus: business loans by the lender secured by borrower's assets. What events can occur that may impede the borrower's ability to collect its accounts (A/Rs) or detrimentally affect the lender's lien?
- b. Objective: (1) Improve the ability of lenders to spot potential problems a borrower may have collecting its accounts and issues that may arise in the

event the lender must enforce its lien with respect to collateral; (2) improve the ability of companies involved in construction projects to protect the value of their assets.

- c. Obtaining the lien in borrower's assets.
 - i. Security agreement and perfection – requirements.
 - ii. Focus on typical collateral: A/R, inventory, equipment.
 - iii. Perfect lender's interest by filing.

2. *Obtaining and Perfecting A Security Interest In Personal Property.*

- a. Definition of a “security interest”: an interest in personal property or fixtures which secures payment or performance of an obligation. Com. Code §1201(35). A security interest is consensual, by agreement; a lien is not necessarily consensual, can be statutory (mechanics lien, judgment lien, tax lien, producer’s lien, etc.)
- b. Definition of a “security agreement”: An agreement that creates or provides for a security interest. Com. Code §9102(a)(73).
- c. “Attachment” of a security interest. Com. Code §9203(a).
 - i. Attachment makes a security interest enforceable against a debtor.
 - ii. Elements of attachment:
 - 1. value given to a debtor;
 - 2. debtor has the right to transfer an interest in the collateral;
 - 3. debtor agrees to the granting of the security interest.
Usually this agreement is evidenced by an authenticated security agreement.
 - 4. alternative: control or possession may be given with the agreement of the debtor.
 - iii. Description of collateral. The description must reasonably identify the collateral to be sufficient. Com.Code §9108. Reasonably flexible. Specific listings or categories acceptable. Financing statement, but not security agreement, may simply describe “all events” or “all personal property” of debtor.
 - iv. In a commercial context, a security interest may attach to after acquired property, including inventory and receivables (“accounts”) (exceptions: commercial tort claims). Specify in security agreement and financing statement.
- d. Perfection. Com.Code §§ 9308 et seq.

- i. Perfection and priority of rights in the collateral. Perfection is required to obtain priority vs. other creditors, transferee, and a lenderruptcy trustee.
- ii. Filing a financing statement vs. possession or control: sometimes there is more than one way to perfect. Com.Code §§9308-9314.
 1. Except as otherwise provided in subsection (b), a financing statement must be filed to perfect all security interests (§9-310(a)).
 2. Perfection without filing: Possession
 - A. §9-130(b) Filing not necessary to perfect:
If in secured party's possession (§9-313)
 - B. §9-313 A secured party may perfect a security interest in negotiable documents, goods, instruments, money, or tangible chattel paper by taking possession of the collateral. Possession may be constructive, as when a bailee holds goods. Perfection by issuance of a warehouse receipt in secured party's name; by notice to bailee; or by filing a financing statement. §9-312.
 3. Perfection without filing: Control
 - A. §9-310(b) Filing not necessary to perfect:
(8) if perfected by control (§9-314)
 - B. §9-314(a) A security interest in investment property, deposit accounts, letter-of-credit rights, or electronic chattel paper may be perfected by control under §9-104 (deposit account), §9-105 (electronic chattel paper), §9-106 (investment property), §9-107 (letter of credit).
 - C. §9-102(a)(29) "Deposit account" means an account maintained with a lender. The term does not include accounts evidenced by a Certificate of Deposit
 4. Perfection without filing: Deposit Accounts
 - A. §9-104 A secured party has control of a deposit account if:
 - The secured party is the lender with which the deposit is maintained;
 - The debtor, secured party, and the lender have agreed in an authenticated record that the lender will comply with instructions originated by the secured party;
 - The secured party becomes the lender's customer (4-104(a)(5)).

5. Perfection without filing: Automatic Perfection
 - A. §9-310(b) Filing not necessary to perfect:
 - (2) if perfected when it attaches automatic perfection (§9-309)
 - B. The following security interests are perfected when they attach: ...
 - (1) a purchase-money security interest (PMSI) in consumer goods, except as provided in §9-311.

iii. Financing Statements (Form UCC-1)

1. In California, must use national form of financing statement (UCC-1).
2. Include information as required by printed instructions.
3. Use debtor's full legal name Com.Code §9506 (Terrance, not Terry; Armando Munoz Juarez, not Armando Munoz); do not use dba or trade name in box 1; for an entity, confirm legal name.
4. Where to file: where debtor is "located". An *individual*--at principal residence. A *registered organization* (corporations, LLCs, limited partnerships)--in the state in which it was organized. Com.Code §9-307(e), e.g. debtor's state of incorporation Com.Code §§9301; 9501. Other organizations (not "registered", such as general partnerships, business trusts)—at chief executive office.

iv. Priority: General Rule: first in time wins. Com.Code §9322(a)(1).

v. Pre-filing: secured party can establish superior position even if security agreement executed later, loan funded later, collateral acquired later.

vi. Priority when control is allowed: Control prevails over a filing with respect to deposit accounts, investment property and rights under letters of credit.

vii. Lenderruptcy trustee's avoiding powers; may gain priority over secured party if unperfected, perfected within 90 days of lenderruptcy to secure pre-existing debt, etc.

1. Preferences - [11 U.S.C. § 547](#)
2. Federal fraudulent transfer - [11 U.S.C. § 548](#)
3. "Strong arm powers": non-lenderruptcy law creditor - [11 U.S.C. § 544](#). Trustee may exercise rights a creditor would have under the state law, including avoidance rights of (a) a

- judicial lien creditor, (b) an unsatisfied lien creditor, and (c) a bona fide purchaser of real property.
- viii. Farm products (crops, livestock); file with Secretary of State as with other goods. Requirement to record in real estate records abolished. Perfected security interest in growing crops trumps even earlier-recorded conflicting interest of real estate claimant (mortgagee, etc.) if debtor has interest of record in the real property or is in possession of it. Com.Code §9334(i).
 - ix. Timber to be cut: file in real estate records where timber is situated.
 - x. Fixture Filings: As between secured parties, first to file with either SOS or real estate records wins, but in order to take priority over holder of interest in real property (mortgage lender, buyer of property, mechanics lien claimant, etc.) secured party must file in real estate records. “Fixtures” are goods that become so related to real estate that an interest in them arises under real property law. §9102(a)(41).

3. Basics of mechanic's liens.

- a. Private projects – “works of improvement.”
 - i. A work of improvement is the construction, alteration, expansion or repair, in whole or in part, of any building, wharf, bridge, ditch flume, aqueduct, well, tunnel, fence, machinery, railroad or road... demolition of buildings; (the definition is not exclusive or exhaustive).
- b. Persons entitled to obtain a lien – anyone who, at the request of the owner or its agent, furnishes labor, services, materials or equipment to a work of improvement.
 - i. Includes mechanics, materialmen, contractors, subcontractors, laborers, suppliers, lessors of equipment, architects, registered engineers, machinists, builders, teamsters. (Civ.Code §3110.)
 - ii. Examples of agents of the owner:
 - 1. Contractor (including general contractor and subcontractor)
 - 2. Architect
 - 3. Engineer (if hired by owner or contractor)
 - iii. Examples of persons who are not agents of the owner:
 - 1. Equipment vendor/ lessor
 - 2. Materials supplier

3. Lender (unless lender takes control of project)
- c. Procedures for obtaining a lien: set forth in CA statutes (covered below). Timing and deadlines are critical.
 - i. Preliminary Notice (not required for those dealing directly with owner; however, may be required for stop notices to lender).
 - ii. Mechanic's Lien
 - iii. Filing the claim (commence legal action).
- d. Stop Notices and Payment Bonds.
 - i. Stop Notices: to withhold unexpended construction funds in the hands of owner or lender.
 - ii. Payment Bonds (if available): credit of surety (insurer, bonding company) is substituted for that of contractor. Can protect subcontractor who fails to serve preliminary notice.
- e. Simultaneous pursuit of remedies: It is recommended that a claimant simultaneously pursue mechanics' lien, stop notice and payment bond remedies.
- f. Licensing requirements: to enforce the mechanics' lien (or even to recover payment on contract with owner), a contractor or subcontractor must be licensed in California.
- g. Examples of those not required to hold a license: suppliers, manufacturers (deemed suppliers), laborers, equipment lessors.

4. Assessing Borrower's Rights In Collateral (Borrower's Right To Be Paid On Its A/R) And Competing Claims.

- a. Mechanic's liens and related issues. *Cautionary note: the deadlines described herein may be subject to change based on the particular facts concerning a project. They are set forth here to provide an understanding of the framework the California statutes employ to govern mechanic's lien rights.*
 - i. Borrower is a contractor or subcontractor.
 1. A contractor (including a general contractor) has a contract directly with the owner. A sub-contractor is engaged by an agent of the owner.

2. Preliminary Notice.

- A. A sub-contractor must serve a preliminary 20 day notice within 20 days of the date it commences work. Service is made on the owner, the contractor and the lender.
- B. A contractor, including a general contractor, does not need to serve the owner, but if it wishes to enforce stop notice rights it must serve a preliminary 20 day notice on the lender.
- C. Unless exempt, a party who may become a claimant under a statutory payment bond must serve either a preliminary 20 day notice or an alternative notice permitted under the Civil Code, which may be done later in time.

3. File a mechanic's lien after completion or cessation of work.

- A. For a general contractor, a mechanic's lien generally cannot be filed before such time all work is completed. If a notice of completion is recorded, claims must be filed within 60 days thereof. Otherwise, the mechanic's lien generally must be filed within 90 days after completion of the work of improvement or 150 days after continuous cessation of work. However, this area is the subject of numerous complicated variations and factual tests as to when completion occurred, whether a cessation of work occurred, and similar issues.
- B. A subcontractor generally can file a mechanic's lien after it has completed its work on the project, and must file not later than 30 days after recordation of a notice of completion for the project or 90 days after completion of the work of improvement if no notice of completion is recorded, or 150 days after continuous cessation of work. Specific exceptions exist with respect to these timeframes, based on the factual situation concerning completion, notices filed, and cessation of work.

4. Serve stop notices and payment bond demands, if appropriate. As with mechanic's liens, specific deadlines exist, which may be subject to variation based on facts.

5. Commence legal action within 90 days of filing mechanics' lien. If not, mechanic's lien is released by operation of law.

ii. Borrower is a materials supplier to the work of improvement.

1. A person who, at the request of the owner or its agent, furnishes materials or supplies to be used or consumed in any work of improvement. Civ. Code §3090.

2. Distinction between a supplier and a sub-contractor can be important to those contracting with them. Tests: Is there a labor component? Is the material being supplied standard stock-in-trade material or, alternatively, have items been specially fabricated to comply with the plans and specifications of the prime contract?

3. Serve a preliminary 20 day notice within 20 days of the date materials are delivered to the work of improvement. However, if supplier has a direct contract with the owner, no notice is needed unless supplier wishes to preserve its rights to file a stop notice, in which case a 20 day preliminary notice must be served on the lender.

4. File a mechanic's lien after delivery of all supplies. This must be filed within 30 days after recordation of a notice of completion or 90 days after completion of the work of improvement or 150 days after continuous cessation of work. Specific exceptions may exist with respect to these timeframes.

5. Serve stop notices and payment bond demands, if appropriate.

6. Commence legal action within 90 days of filing mechanics' lien. If not, mechanic's lien is released by operation of law.

iii. Borrower is an owner.

1. An owner is a person with interest in the real property where the work of improvement (project) is occurring. Owner does not have to hold the "fee interest." For example, could be the lessee holding a ground lease.

2. Traditional construction lending issues arise when the loan is a construction loan, which are beyond the scope of this seminar.
- iv. Borrower is an architect or professional. Its rights generally parallel those of contractors or sub-contractors, depending upon whether the architect or professional was engaged by the owner or an agent of the owner.
- b. Purchase Money Security Interests (PMSI) and Competing Liens in collateral.
 - i. A PMSI is a security interest in goods or software that secures an obligation incurred as all or part of the price of the collateral. The holder of a PMSI has a super-priority over other lienholders.
 - ii. The routine sale of goods does not itself create a security interest in favor of the seller. The parties must so agree.
 - iii. Equipment (Com.Code §§9103; 9317; 9324.)
 1. Holder of the PMSI has priority if it perfects within 20 days of the date the debtor receives the collateral.
 2. Priority extends to identifiable proceeds of collateral (excluded: inventory unless strict factors are met). Issue: how can “proceeds” be identified? Disputes arise.
 - iv. Inventory (Com.Code §9324.)
 1. Party asserting PMSI must satisfy particular requirements, including prior perfection of the security interest (no 20 day grace period), delivery of notices prior to delivery of inventory.
 2. PMSI does not extend to accounts that are proceeds of the sale of inventory. A lender holding a blanket lien, including A/R will prevail.
 - A. However, funds placed in a segregated deposit account as payment, simultaneously with delivery of the goods, will be identifiable proceeds and priority will be held by the holder of the PMSI.
- c. Inventory in possession of a bailee or warehouseman

- i. Unless the lender has an agreement with the warehouseman, he/she/it will have a prior lien for storage costs.
 - ii. Inventory in the possession of a vendor/ supplier.
 - 1. Delivery of inventory to a vendor, for build out.
 - 2. Purchase of goods from a vendor, to finance build out.
 - iii. Can utilize security/ transfer agreements, UCC financing statements, newspaper notices, and physical segregation of goods to preserve borrower's rights in goods held at a vendor's facility.
- d. Producer's Liens and other Agricultural Liens; see Appendix.
- i. Most agricultural liens are perfected by filing; priority and enforcement are governed by the UCC.
 - ii. Other ag liens, including producer's liens, are possessory or otherwise do not require filing.
- e. Tax liens.
- i. Arises as a result of borrower's failure to pay certain tax obligations.
 - ii. Tax liens against a corporation or partnership with a principal office in California, or a trust, will be filed with the Secretary of State. Tax liens may also be filed in the county where the debtor resides.
 - iii. For non-floating liens: a tax lien will be junior to a security interest filed before the notice of tax lien is filed, but see below.
 - iv. Floating liens and after acquired property. IRS liens will take priority on after acquired property (A/R, inventory) after 45 days following the notice of tax lien.

5. Secured Party's Rights after Property is Transferred; Proceeds of Collateral.

- a. General rule: Security interest continues in collateral even after it is sold, leased, licensed, or otherwise transferred unless the secured party authorized the disposition free of the security interest. Also, security interest attaches to identifiable proceeds of collateral. (Com.Code §9315(a). There are many exceptions, including sales in the ordinary course of the debtor's business, sales by a merchant to whom the secured party entrusted the goods, etc.

- b. If proceeds are not goods and are commingled, tracing rules and equitable principles apply.
 - c. If security interest in original collateral was perfected it remains perfected in the proceeds thereof:
 - i. For 20 days (to enable action to perfect in proceeds); and
 - ii. Thereafter if (A) action is taken to perfect in proceeds as new collateral; or (B) a filed financing statement covered original collateral, proceeds are collateral in which perfection is permitted by filing, and the proceeds are not acquired with cash proceeds; or (C) in identifiable cash proceeds. §9315(c) and (d).
 - d. The priority of rights in proceeds of collateral follow the priority established by perfection of security interests in the collateral. The time of filing usually will govern.
 - e. Issue: cash proceeds put in a separate deposit account not at CBB. Another lien holder in such account could obtain priority.
 - f. Need for deposit account control agreement.ⁱ
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APPENDIX

Witkin on Agricultural liens:

(1) Agricultural Chemical and Seed Lien. Food & Ag.C. 57551 et seq. create a lien in favor of a provider of agricultural chemicals or seeds. (See 22 Pacific L. J. 354.)[*pg.269]

(a) Lien on proceeds of crop. The provider of agricultural chemicals or seeds, who has sent the debtor notice of overdue payments as provided in Food & Ag.C. 57561(a), has a lien upon the proceeds of the crop for the reasonable or agreed charges for the chemicals or seeds, and for the costs of enforcing the lien. (Food & Ag.C. 57561(b).) The amount of charges secured by the lien cannot exceed the reasonable or agreed charges for chemicals furnished within a 60-day period, and for seeds furnished within a 45-day period. (Food & Ag.C. 57561(d).)

(b) Effective period of notice of claim. The notice of claim of lien remains effective so long as the provider of agricultural chemicals or seeds (a) remains unpaid for amounts secured by the lien, or (b) continues to provide chemicals or seeds on a regular basis to the lien debtor. (Food & Ag.C. 57562 [chemicals or seeds are not provided on ``regular basis" when more than 45 days elapse between deliveries].)

(c) Perfection of lien. The lien is perfected upon filing a notice of claim of lien with the Secretary of State. (Food & Ag.C. 57563; on information to be included in notice, see Food & Ag.C. 57565; on form of notice, see Food & Ag.C. 57567.) The lien claimant must provide written notice of the claim of lien to the lien debtor within 10 days of filing. (Food & Ag.C. 57569.)

(d) Priority. The lien has priority in accordance with the time the notice of claim of lien is filed (Food & Ag.C. 57575(a)), and has the same priority as a security interest perfected by the filing of a financing statement as of the date the notice of claim of lien was filed (Food & Ag.C. 57575(b)). (On priority of security interests generally, see 4 Summary (10th), Secured Transactions in Personal Property, §105 et seq.) The lien does not have priority over labor claims for wages and salaries for personal services provided to a lien debtor in connection with the production of agricultural products. (Food & Ag.C. 57575(c).)

(e) Applicability of Commercial Code. Except as otherwise specifically provided, the agricultural chemical and seed lien is subject to U.C.C. 9101 et seq. (Food & Ag.C. 57591.)

(f) Assignability and transferability. The lienholder may assign or transfer the lien by filing a statement of assignment or transfer with the Secretary of State in the same manner as a secured party would do under U.C.C. 9514. (Food & Ag.C. 57590; see 4 Summary (10th), Secured Transactions in Personal Property, §101.)

(g) Notice to secured creditors. The lien claimant must provide written notice to secured creditors at least 30 days before enforcing a claim of lien. (Food & Ag.C. 57585.)[*pg.270]

(h) Foreclosure. A lien claimant may foreclose on the lien only in an action to recover the reasonable or agreed charges for agricultural chemicals or seeds provided. (Food & Ag.C. 57586.)

(i) *Termination statement. A lien claimant who receives payment and who has not been providing agricultural chemicals or seeds for 45 consecutive days must send the lien debtor a statement that the lien claimant no longer claims a security interest. The statement must be sent within 10 days or the lien claimant is liable for actual damages, as well as a penalty of \$100 if the failure was in bad faith.* (Food & Ag.C. 57587(a).)

(2) Similar Liens. Virtually identical statutory schemes govern dairy cattle supply liens (Food & Ag.C. 57401 et seq.; see 19 Pacific L. J. 467) and poultry and fish supply liens (Food & Ag.C. 57501 et seq.; see 22 Pacific L. J. 354).[*pg.271]

[§245] Agricultural Supply Liens. [Supp]

[*spg.56]p. 270:

(2) Similar Liens.

*(New) Producer's lien on farm products held by processor: Food & Ag.C. 55631 et seq. govern farmers' and growers' liens on farm products sold and delivered to processors. Food & Ag.C. 55638 gives a producer the right to be paid from the proceeds of a sale of the farm products. Under Food & Ag.C. 55633, the producer's claim to the proceeds is a lien, with priority over almost all other liens, claims, and encumbrances. (Frazier Nuts v. American AG Credit (2006) 141 C.A.4th 1263, 1274, 1277, 46 C.R.3d 869 [almond growers' claims to proceeds of sale of almonds had priority over lender's security interest].)[*spg.57]*

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ⁱ These materials were prepared in connection with a presentation by the authors in September 2011