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DRAFTING THE SECURITY AGREEMENT

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Outline of program

- Issues in drafting security agreements
- For each topic, first the legal background
- Then sample “good” and “bad” provisions

The UCC and freedom of contract

- UCC § 1-302:

(a) Except as otherwise provided in subsection (b) or elsewhere in [the Uniform Commercial Code], the effect of provisions of [the Uniform Commercial Code] may be varied by agreement.

(b) The obligations of good faith, diligence, reasonableness, and care prescribed by [the Uniform Commercial Code] may not be disclaimed by agreement. The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable. Whenever [the Uniform Commercial Code] requires an action to be taken within a reasonable time, a time that is not manifestly unreasonable may be fixed by agreement.

(c) The presence in certain provisions of [the Uniform Commercial Code] of the phrase "unless otherwise agreed", or words of similar import, does not imply that the effect of other provisions may not be varied by agreement under this section

- UCC §§ 9-602 and 9-624 discussed later

When do you need a security agreement?

- Article 9 applies to a security interest in all types of personal property
- Meaning of 'security interest' (§ 1-201(b)(35))
- Sales of payment rights in all forms
- Hidden secured transactions
 - 'Dirty' leases (§ 1-203)
 - 'Sales' transactions
- Consignments

Attachment of a security interest

- Needed for perfection and priority
- Attachment:
 - Security agreement (§ 9-203(b)(3))
 - Rights in the collateral (§ 9-203(B)(2))
 - Give value (§ 9-203(b)(1))

What's needed in a "security agreement"

- Agreement must create or provide for a security interest (§ 9-102(a)(73))
- In transactions covered by Article 9, this includes:
 - Consignment agreement
 - Sales agreement
 - Lease that is treated as creating a security interest

Description of the collateral

- Must 'reasonably identify' the collateral
- May not use 'all assets' description in security agreement
- OK to describe collateral by 'type' or 'category'
- Description by 'type' not sufficient in some circumstances:
 - Commercial tort claims
 - Consumer transaction involving consumer goods, securities entitlement, or securities account
- Under 2022 Amendments, creation of a security interest in a "CER" does not create a security interest in any controllable accounts or controllable payment intangibles evidenced by the CER
- Nor does creation of a security interest in controllable accounts or controllable payment intangibles evidenced by a CER create a security interest in the CER

The Basics

- Parties
 - Debtor
 - Secured party
 - Agent, trustee or other representatives
- Recitals
- Definitions
 - UCC defined terms
 - Terms defined in more than one UCC Article
- *Bad examples*
 - *"Debtor grants to the lenders a security interest in [the collateral]" ignoring the agent for the lenders*
 - *The collateral includes "accounts" defined as "all rights to payment."*
 - *The collateral is described as "contract rights."*
 - *The collateral consists of all rights to payment consisting of controllable electronic records.*

Future advances

- Security interest may secure future advances (§ 9-204(c))

Granting Language (1)

- Granting language
 - Obligations secured
 - advances made
 - advances to be made (“future advance” clause)
 - other obligations
 - Description of the collateral
 - use of UCC defined terms
 - no super-generic terms
- *Bad examples*
 - *“Debtor grants to secured party a security interest in [the collateral]” but then fails to mention the obligations secured.*
 - *“Debtor grants to Secured Party a security interest in all of Debtor’s personal property.”*
 - *“Debtor grants to Secured Party a security interest in [the collateral] in the amount of the loan.”*
 - *“Debtor grants to Secured Party a security interest an undivided interest in [the collateral] up to the amount of the loan.”*

After-acquired collateral

- Generally allowed (§ 9-204(a))
- Not permitted (§ 9-204(b)):
 - Commercial tort claims
 - Consumer goods, unless acquired within ten days of secured party giving value
- In security agreement should refer to 'after-acquired' collateral or the like (§ 9-108, Comment 3)

Granting Language (2)

- Granting language – caveats concerning referring to
 - Location of collateral
 - After-acquired assets
 - Debtor's ownership of the collateral
- *Bad examples*
 - *"Debtor granted to Secured Party a security interest in Debtor's inventory and equipment located at the Chrysler Building in New York City."*
 - *"Debtor grants to Secured Party a security interest in Debtor's inventory."*
 - *"Debtor grants to Secured Party a security interest in all inventory owned by Debtor."*
 - *"Debtor grants to Secured Party a security in [the collateral] included in the Borrowing Base."*

Limits on transferability of collateral

- Generally overridden in full for rights to payment (§ 9-406(d) and (f))
- For other kinds of rights, can create security interest, but cannot force counterparty to acknowledge rights of secured party (§ 9-408)
- Note that some state entity laws (e.g., Delaware) do not allow UCC to override entity restrictions on transfer (whether in entity statute or agreement creating the entity)

Proceeds (§ 9-102(a)(64))

- Security interest in proceeds automatically attaches if security interest has attached to original collateral (§ 9-203(f))
- Security interest may 'detach' after 20 days if certain requirements are not met (§ 9-315)

Attachment

- Attachment issues
 - Commercial tort claims
 - Non assignable collateral
 - Types affected
 - Investment property (Article 8 partnership interest)
 - General intangibles (Article 9 partnership interest)
 - Mitigating provisions
 - Restriction must be enforceable under 9-406 to 9-408
 - Consent granted
 - Proceeds
 - *Bad example*
 - *"Debtor grants to Secured Party a security interest in all claims which the Debtor may have, whether in contract or tort."*
 - *"Debtor grants to Secured Party a security interest in [the collateral] upon Debtor's default."*

Perfection and Priority (1)

- Authorization to file financing statement
 - broader collateral indication
 - “all assets”
- Other perfection steps
 - Promissory notes and chattel paper in tangible form
 - Deposit accounts
 - Investment property
 - Impact of Hague Securities Convention
 - Collateral in the possession of a bailee

Perfection and Priority (2)

- Other perfection steps
 - Electronic collateral
 - chattel paper in electronic form
 - transferable records under E-Sign or UETA
 - electronic documents
 - controllable electronic records, controllable accounts, and controllable payment intangibles (2022 UCC amendments)
 - Letter-of-credit rights
 - Commercial tort claims
 - Other actions

Security interest in supporting obligations and underlying collateral

- Security interest automatically created when security interest is created in:
 - Supported obligation (§ 9-203(f)) or
 - Secured obligation (§ 9-203(g))

Other Security Documents

- Relation to other documents
 - Stock pledge agreement
 - Patent and trademark assignments
 - Copyright memorandum
 - Real estate documents
- *Bad example*
 - *Security agreement: "A failure to pay in 5 days from the due date is a default."*
 - *Stock pledge agreement: "A failure to pay in 10 days from the due date is a default."*

Financing statement – debtor name

- Must be exactly correct
- For registered organization: copy exactly from organizational documents
- Individuals
 - What is the 'name'?

Financing statement – debtor location

- ‘Location’ of debtor:
 - Registered organization (corporation, LLC, LP): state of organization (§ 9-307(e))
 - New rules for certain business trusts
 - Partnership: state of chief executive office (§ 9-307(b)(3))
 - Individual: state of principal residence (§ 9-307(b)(1))
 - Non-US entity: country of chief executive office, if country has filing system for the collateral (§ 9-307(c))

Representations and Warranties – Legal Status

- Representations and warranties concerning the debtor's legal status
 - Debtor's name
 - Organization debtor
 - Individual debtor
 - Debtor's type and jurisdiction of organization
 - Debtor's chief executive office
 - Debtor's mailing address

Financing statement – post-closing events

- Change in debtor's name (§ 9-507(c))
- Debtor becomes located in different jurisdiction (§ 9-316(a)(2))
- Collateral transferred to a different debtor
 - Same jurisdiction (§§ 9-315(a)(1) + 9-507(a))
 - Different jurisdiction (§ 9-316(a)(3))
- Some changes in recent amendments

Covenants as to Legal Status

- Covenants concerning the debtor's legal status: No change of debtor's
 - name
 - chief executive office
 - mailing address
 - type of organization, jurisdiction of organization or other legal structure

Representations and Warranties - Collateral

- Representations and warranties concerning the collateral
 - Rights in or power to transfer rights in the collateral
 - Lien status
 - Perfection certificate
 - Farm products
 - Governmental account debtors
 - Fair Labor Standards Act compliance
 - Controllable electronic records, controllable accounts, and controllable payment intangibles (2022 UCC amendments)
- *Bad example*
 - *"Debtor owns all of the inventory collateral."*

Covenants as to the Collateral (1)

- Covenants concerning the collateral
 - Location of the collateral
 - Maintenance of rights in or power to transfer rights in the collateral
 - Negative pledge
 - “Becoming bound” by a security interest in favor of another person

Certain transferees against perfected secured party

- Buyer in ordinary course of business takes free of earlier perfected security interest (§§ 9-320 + 1-201(b)(9))
- Lessee in ordinary course of business takes free of earlier perfected security interest (§ 9-321(c))
- Non-exclusive licensee in ordinary course of business takes free of earlier perfected security interest (§ 9-321(b))

Covenants as to the Collateral (2)

- Covenants concerning the collateral
 - Maintenance of collateral
 - Compliance with law
 - Environmental
 - Fair Labor Standards Act
 - No disposition of collateral except in ordinary course
 - Inventory
 - General intangibles
 - Controllable electronic records, controllable accounts, and controllable payment intangibles (2022 UCC amendments)

Insurance

- Insurance
 - Maintenance of insurance
 - Secured party as loss payee
 - “Standard mortgagee” loss payee clause
 - Additional insured (?)
 - Notification of any cancellation of the policy
 - Use of proceeds to repair or replace or application against secured obligations
 - reduction of revolver commitment

Protecting the Collateral

- Collateral protection expenses
 - Right but no duty
- Right for collateral to be registered in the secured party's name
- Right of set-off, regardless of adequacy of the collateral

Right to Exercise the Debtor's Rights

- Right to notify account debtors or other obligors on collateral
 - Especially if the right is given before a default has occurred
- Power of attorney

Default

- Secured party's rights dependent on "default" unless otherwise agreed (§ 9-601(a))
- Article 9 does not define default

Default

- Rights and remedies
 - Defining a “default”
 - Rights of secured party under law of the state
 - Access to data
 - Agreed period for notice of disposition
 - Credit bidding
- Beware of incurable grace periods
- *Bad example*
 - *“It shall be a default if Debtor shall die and remain dead for a period of 30 days.”*

Enforcement – limitations on waivers

- UCC § 9-602:

Except as otherwise provided in Section 9-624, to the extent that they give rights to a debtor or obligor and impose duties on a secured party, the debtor or obligor may not waive or vary the rules stated in the following listed sections:...

- UCC § 9-624:

(a) [Waiver of disposition notification.]A debtor or secondary obligor may waive the right to notification of disposition of collateral under Section 9-611 only by an agreement to that effect entered into and authenticated after default.

(b) [Waiver of mandatory disposition.]A debtor may waive the right to require disposition of collateral under Section 9-620(e) only by an agreement to that effect entered into and authenticated after default.

(c) [Waiver of redemption right.]Except in a consumer-goods transaction, a debtor or secondary obligor may waive the right to redeem collateral under Section 9-623 only by an agreement to that effect entered into and authenticated after default.

- 1-302(b) (mentioned before):

The parties, by agreement, may determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable.

Enforcement (1)

- Standards for exercising rights and remedies
 - Internet dispositions
 - Digital assets
- Suretyship waivers

Signatures

- Security agreement must be “authenticated” (pre-2022 Amendments) or “signed” (2022 Amendments)
- Limited cases for “oral” security agreements
 - Possession or control of collateral combined with oral agreement

Enforcement (2)

- No marshaling
- Proceeds of collection or disposition
 - Expenses
 - Order of application to secured obligations
 - Non-cash proceeds
 - Allowance for secured obligations not yet due
 - Turnover to junior secured parties
- Debtor liable for a deficiency
 - Caveat for limited recourse transactions

Other Provisions

- Overdue amounts
- Governing law
 - Contractual vs. both contractual and non-contractual
- Choice of forum
 - Exclusive vs non-exclusive
 - Impact of staggered effective dates under the 2022 UCC amendments
- Waiver of jury trial
 - “To the extent permitted by law...”
- Miscellaneous
 - Agreement as to electronic commerce

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