Protecting Your Business Assets Used As Collateral For Loans

When you borrow money to finance your business, your lender will, of course, want to make sure that you repay the loan. Even if you have incorporated your business, your lender will probably require you to guarantee the loan personally. Moreover, your lender will almost always require you to pledge your business assets as well.

Whenever you pledge your personal or business assets as security for a loan, that transaction is governed by a statute known as the Secured Transactions provisions within the Uniform Commercial Code (or UCC). This article will discuss some pertinent feature of the Secured Transactions provisions of the UCC from the perspective of the borrower.

Setting Out the Terms of the Security Agreement

Your lender's interest in the assets that you pledge as security for a loan is called a security interest. In order to have a security interest, your lender must obtain your signature on a written agreement called a security agreement. The security agreement must describe the assets that you are pledging as security for the loan. Those assets are known as collateral. The security agreement is a very important document. It specifies your lender's rights and duties regarding the collateral if you do not repay the loan.

Lenders may obtain a security interest in almost any type of collateral, including intangible assets (such as your right to receive royalties or even the goodwill of your business), accounts receivable, inventory, fixtures, and equipment. Generally, the security agreement will cover all these types of collateral. If you want to exclude a particular type of collateral (such as the goodwill of your business), you must make sure to exclude it from the security agreement.

You will generally have possession of the collateral that is subject to the security agreement. For example, if your loan is secured by your equipment, the equipment will remain in your possession. However, if you have possession of the collateral, how does your lender know that you won't also pledge it to some other lender? Lenders protect themselves by perfecting their security interests. A security interest in property other than real estate is perfected by filing a document known as a financing statement with the Illinois Secretary of State.

The financing statement describes the collateral that is subject to the security agreement. Financing statements are public documents, and anyone can examine them. The financing statement constitutes notice to all subsequent lenders that your lender has a security interest in the collateral described within the statement. The UCC provides that whoever files the financing statement first will also be repaid first if the collateral is sold to repay the loan.

Default and Recouping Losses

If you are unable to repay the loan, you will be in default. If you are in default, your lender may sue you to collect the unpaid loan proceeds. Your lender may also enforce the security agreement by foreclose the security interest. Foreclosure is the method by which lenders repossess and dispose of the collateral.

If you have possession of the collateral and you are in default, most security agreements permit your lender to repossess the collateral. A lender repossesses collateral by entering your residential or business property and simply removing it. In cases involving accounts receivable, your lender may notify your customers that it has a security interest and request that they send future payments to the lender. If your security agreement requires it, or if for some reason your lender is unable to repossess the collateral, your lender can seek a court order requiring you to give up the collateral. Check the security agreement to see whether the lender must obtain a court order before it can repossess your business assets. It could be in your interest to have such a clause.

Lenders repossess collateral so that they can lease or sell it and apply the proceeds toward the unpaid loan. Unless your security agreement provides otherwise, your lender can make reasonable expenditures to recondition or refurbish the collateral in advance of the sale or lease. The lender's costs in doing that work will be added to your unpaid debt.

The UCC requires lenders to apply the proceeds of the disposition of collateral in the following order. First, the proceeds are applied to the reasonable expenses of repossessing, storing, refurbishing, and selling or leasing the collateral. These expenses may include attorneys fees and related legal expenses. Next, the proceeds are applied to satisfying the debt. Finally, any remaining proceeds are refunded to the borrower. Thus, if the value of the collateral could exceed the amount of your unpaid debt, the manner in which the sale is conducted may affect you financially.

Once you are in default, your lender will probably try to use the easiest, quickest method for disposing of the collateral. That method may not ultimately bring about the greatest recovery. Depending on the value of the collateral and the amount of the debt, the quick and easy method may result in the sale of more collateral than may have been absolutely necessary or may diminish the amount of the excess proceeds that the lender must refund to you. For example, assuming that you pledged various types of office equipment as collateral, your lender could sell all the equipment in one package or item by item. If you think your equipment would be worth more when sold individually rather than in one package (or visa-versa), you should attempt to insert a provision in the security agreement requiring that type of sale.

Your lender may dispose of the collateral by a public or private sale and at any reasonable time or place, and in any manner. A public sale usually results in a higher price than a private sale. Therefore, a potentially beneficial provision in the security agreement might require your lender to hold a public sale. Similarly, if you think that a sale at a certain time or place or in a particular manner would result in a higher price, you should attempt to insert a provision in the security agreement requiring such a sale.

The security agreement that your lender presents to you will undoubtedly favor your lender to the greatest extent possible. Changing any of those terms may be quite difficult. Considering the consequences of a default, however, it may be worth trying. For maximum protection, have an attorney review the agreement before you sign it so that you will at least be fully aware of your rights under the agreement.