# **Understanding The Terms Of Security Agreements**



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If you've never thought about it before, get ready for a surprise: there is no such thing as "boilerplate" in a security agreement.

**A "SECURITY AGREEMENT"** is an agreement that creates or provides for an interest in personal property that secures payment or performance of an obligation. Uniform Commercial Code (§9-102(a)(73); §1-201(b)(35)). (All section references used herein are to the Uniform Commercial Code, as in effect on the date hereof.) "Boilerplate," as defined by Bryan Garner, is "ready-made or all-purpose language that will fit a variety of contexts." Garner, Bryan, A Dictionary of Modern Legal Usage (Oxford, 1st ed., 1987). So given the highly technical nature of security agreements, it might seem that they would be fertile soil for boilerplate language of all kinds. As with other exercises in contract drafting there can be a temptation to reach for ready-made language, if not for the sake of relying on a tested model, for the sake of satisfying clients who keep reminding their attorneys not, as they often put it, "to reinvent the wheel." But security agreements don't really lend themselves to boilerplate. Although quite a few provisions of security agreements fall under familiar headings — just like other contracts — the security agreements themselves are by necessity as different as every un-

derlying transaction — also like other contracts. So the purpose of this article isn't to set forth off-the-shelf language, but to discuss how each provision fits into the overall picture of the transaction. The examples are for general reference only; as always, the transaction comes first, and the best way to approach the agreement is to make sure that both sides are perfectly clear about the terms of the deal.

#### RECITALS

**a. Overview:** Recitals explain the transaction, including naming parties thereto, their status, and why they are entering into the security agreement. For attachment of a security interest to occur, the secured party must give value (§9-203(b)(1)); the debtor must have an interest in or the power to transfer an interest in the collateral to the secured party (§9-203(b)(3)(A)); and the debtor must authenticate a security agreement that describes the collateral (§9-203(b)(2)). "Secured party" is defined as the person in whose favor the security interest is granted (§9-102(a)(72)(A)). "Debtor" is defined as (A) a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor; (B) a seller of accounts, chattel paper, payment intangibles or promissory notes; or (C) a cosignee. Note that there are exceptions to the need to authenticate the security agreement: for example, if the collateral is a deposit account, and the secured party has control under section 9-104 pursuant to a security agreement.

# b. Example:

SECURITY AGREEMENT, dated as of \_\_\_\_\_\_\_, between [name of Debtor] ("Debtor"), a [State] [type of registered organization] and [name of Secured Party] ("Secured Party");

WHEREAS, Debtor has entered into a Credit Agreement dated the date hereof (as amended from time to time, the "Credit Agreement") with the Secured Party, pursuant to which the Secured Party, subject to the terms and conditions contained therein, is to make loans to the Debtor;

WHEREAS, it is a condition precedent to the Secured Party's making any loans to Debtor under the Credit Agreement that the Debtor execute and deliver a Security Agreement in substantially the form hereof.

NOW, THEREFORE,

#### **DEFINITIONS**

**a. Overview:** A security agreement is frequently one of many "loan documents" executed in conjunction with a loan. To the extent possible, it is best to keep the definitions in all the loan documents consistent. In addition, the parties must choose which state's U.C.C. governs, and to the extent terms are defined differently in various Articles of the U.C.C., which Article of the U.C.C. governs. For example, "instrument"

under Article 9 includes non-negotiable and negotiable instruments, while "instrument" under Article 3 includes only negotiable instruments (§9-102(a)(47); §3-102(1)(a); §3-104(b)).

Also, the Article 9 definition may not always be beneficial. For example, the U.C.C. definition of a commercial tort claim is "any claim," thus making it difficult for a debtor to know when it has a claim and difficult for a secured party to enforce a debtor default for failure to report the existence of such a claim. Thus, both parties benefit from inserting a clear standard into the U.C.C. definition of "Commercial Tort Claim."

Similarly, the U.C.C. definition of "Deposit Accounts" includes all deposit accounts, including payroll accounts. For reputational and liability reasons, a secured party generally does not want to exercise control over a payroll account and therefore is usually willing to exclude payroll accounts from the U.C.C. definition of deposit accounts, or alternatively, to exclude payroll accounts from the perfection requirement.

It may make sense to exclude certain personal property from collateral, thereby creating a need for a definition of "Excluded Collateral." For example, a secured party may not want to spend time reading all of the debtors' contracts and therefore usually will include an exclusion for contracts that have an enforceable anti-assignment provision. If a foreign subsidiary provides credit support of any type beyond a two-thirds pledge of its stock, the foreign subsidiary is deemed to have paid a dividend to the U.S. parent equal to the principal amount of the loan to the extent of the foreign subsidiary's earnings and profits. Thus, any such credit support beyond the two-thirds pledge can result in "phantom income" (i.e., taxable income without corresponding cash) to the U.S. parent. See section 956 of the Internal Revenue Code. Secured parties do not want their debtors to incur taxable phantom income and therefore will generally exclude from a U.S. loan voting stock of foreign subsidiaries in excess of 65 percent. Similarly, it may not be worth the borrower's effort and expense to perfect a security interest in certain assets, including goods subject to a certificate of title, if such personalty constitutes a minimal amount of the debtor's assets, so secured parties are frequently willing to exclude such personalty. A debtor does not want to lose the benefit of its bargain in the credit agreement and therefore will want to exclude capital leases, purchase money financings and cash to secure letter-of-credit rights, to the extent they prohibit other liens and are permitted under the credit agreement.

Some states adopted non-uniform provisions of the U.C.C., so be cognizant of which state's U.C.C. is chosen to govern. For example, a question sometimes arises as to whether an annuity is a contract of insurance that is excluded from the scope of Article 9 by section 9-109(d)(8), or whether it is a general intangible. New York concluded that an annuity contract is a contract of insurance, and is therefore excluded from the scope of Article 9. A secured party lending to a debtor that holds valuable annuity contracts may wish to designate law other than the New York U.C.C. to govern. Also, some states (for example, New York) did not adopt the Article 9 override of statutory anti-assignment clauses. Another non-uniform provision to be aware of is whether the state's U.C.C. is applicable to government debtors. Typically, the U.C.C. of the state chosen will be the same state whose law governs the security agreement as a matter of contract between the debtor and the secured party.

Moreover, certain terms must be defined. For there to be a security interest, the interest must secure "payment or performance of an obligation." For drafting simplicity and clarity, consider defining a term to

refer collectively to the secured obligations. "Secured Obligations" can include future advances only if the security agreement so states. However, beware of "dragnet" clauses because courts may not give effect to these provisions (i.e., limit obligation to obligations arising out of the loan documents).

While remedies under Article 9 can only be enforced upon default, Article 9 does not define default. Thus, the security agreement must define "Default" and/or "Event of Default." Without such definition, it is unclear when remedies can be exercised.

**b. Negotiable Provisions:** The definitions in a security agreement are negotiable. The parties may negotiate, for example, whether "Obligations" will cover existing obligations and hereafter arising obligations, or obligations arising under the loan documents or at any time owing to the secured party. As noted, use these dragnet clauses with caution, as courts may not enforce such provisions.

The parties may also negotiate, for example, whether "Excluded Deposit Accounts" will be "Excluded Collateral" or "Unperfected Collateral"; whether "Commercial Tort Claims" must meet value thresholds or must be asserted in a judicial proceeding; or whether "Commercially Reasonable Efforts" require the making of payments or concessions.

## c. Example:

All capitalized terms used herein without definition shall have the respective meanings provided therefor in the Credit Agreement.

All terms defined in the U.C.C. of the State and used herein shall have the same definitions herein as specified therein. However, if a term is defined in Article 9 of the U.C.C. of the State differently than in another Article of the U.C.C. of the State, the term has the meaning specified in Article 9.

"Commercially Reasonable Efforts" means efforts that are commercially reasonable but in no event require the making of payments or material concessions.

"Commercial Tort Claim" has the meaning provided in the U.C.C. except it shall refer only to such claims that have been asserted in judicial proceedings.

"Deposit Accounts" has the meaning provided in the U.C.C. except it shall not include Excluded Deposit Accounts.

"Excluded Collateral" means (1) any property in which the Debtor now or hereafter has rights, to the extent in each case a security interest may not be granted by the Debtor in such property as a matter of applicable law, or under the effective terms of the governing document applicable thereto, without the consent of one or more parties thereto other than any [Loan Party] but only for so long as such consent has not been obtained; (2) assets subject to capital leases, purchase money financing, and cash to secure letter-of-credit reimbursement obligations, to the extent such capital leases, purchase money

financing, or letters of credit prohibit other liens and are permitted under the Credit Agreement; (3) assets sold to a person who is not a [Loan Party] in compliance with the Credit Agreement; (4) assets owned by a [Guarantor] after the release of the guaranty of such [Guarantor] pursuant to Section \_\_\_\_ of the Credit Agreement; (5) vehicles and other goods subject to a certificate of title; (6) any collateral as to which the Secured Party has determined in its sole discretion that the collateral value is insufficient to justify the difficulty, time and/or expense of obtaining a perfected security interest therein; (7) any application for registration of a [Trademark] filed with the United States Patent and Trademark Office (PTO) on an intent-to-use basis until such time (if any) as a statement of use or amendment to allege use is accepted by the PTO, at which time such [Trademark] shall automatically become part of the Collateral and subject to the security interest pledged; (8) any property to the extent that such grant of a security interest is prohibited by any [Governmental Authority], or requires a consent not obtained by any [Governmental Authority]; (9) the issued and outstanding voting capital stock of any first-tier [Foreign Subsidiary] in excess of sixty-five percent (65%) thereof; [(10) any property to the extent that such grant of a security interest would contravene the Agreed Security Principles, and (11) any subsidiary to the extent that Rule 3-10 or Rule 3-16 of Regulation S-X under the Securities Act requires separate financial statements of such subsidiary to be filed with the SEC (or any other governmental agency).] Notwithstanding the foregoing, any and all proceeds of Excluded Collateral, to the extent that the proceeds are not themselves Excluded Collateral, shall be Collateral.

"Excluded Deposit Accounts" means (1) any deposit accounts specially and exclusively used for payroll, payroll taxes, and other employee wage and benefit payments to or for the benefit of the Debtor's salaried employees; (2) escrow arrangements (e.g., environmental indemnity accounts); and (3) deposit accounts not otherwise subject to the provisions of this paragraph, the aggregate average daily balance of which for all Loan Parties does not exceed \$\_\_\_\_\_ at any time.

"Quarterly Update Date" means the date of the delivery of the financing statements pursuant to Section \_\_\_\_ of the Credit Agreement.

"Secured Obligations" means all of the indebtedness, obligations, and liabilities of the Debtor to the Secured Party, individually or collectively, whether direct or indirect, joint or several, absolute or contingent, due or to become due, now existing or hereafter arising (and whether arising before or after the filing of a petition in bankruptcy and including all interest accrued after the petition date) under or in respect of the Credit Agreement, any promissory notes or other instruments or agreements executed and delivered pursuant thereto or in connection therewith, or this Agreement.

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"Unperfected Collateral" means Excluded Deposit Accounts, goods subject to certificate of title laws, and letter-of-credit rights, individually or in the aggregate not in excess of \$\_\_\_\_\_.

#### **GRANTING LANGUAGE**

**a. Overview:** No special language is required to create a security interest. The phrase "grant a security interest" is sufficient. "Grant" and "pledge" can be used synonymously (§9-109; §9-203), but are frequently used together. It is preferable not to use "assign" because that term can connote an outright transfer of ownership when applied to certain intellectual property.

The security agreement must "provide a description of the collateral" (§9-203(b)(3)(A)), and that description of collateral is sufficient if it "reasonably identifies" the collateral. *See also* §9-108(a). "Supergeneric" descriptions such as "all the debtor's assets" and "all the debtor's personal property" are not permitted. Usually, the security agreement will simply use the categories of collateral established by the U.C.C.

An all asset lien can be described by naming each Article 9 category of collateral and then adding "and all other personal property whether governed by Article 9 or other law." *See* §9-108(b)(3) (see definition of "general intangibles" for a list of the Article 9 categories of collateral). Nonetheless, one should be cognizant of certain exceptions and limitations on language used to describe collateral, including:

- 1. "Commercial tort claims" must be described specifically (for example, plaintiff's and defendant's names and a description of the claim) in order for a security interest to attach to such claim (§9-108(e)(i); §9-204(b)(2)). Security agreements generally take this into account by requiring debtors to give prompt notice to the secured party when any commercial tort claim arises and to supplement the security agreement to describe the tort claim.
- **2. "Wherever located"** (this makes clear, for example, that a secured party's security interest will attach to goods located outside of the United States).
- **3. "Whether now owned or hereafter acquired"** will give the secured party a security interest in personal property acquired after the effective date of the security agreement (§9-204(a)). However, remember that the security interest cannot attach until the debtor has rights in the collateral or power to transfer rights in the collateral. After-acquired property must be specifically included in the granting clause to be included in collateral.
- **4. "Proceeds"** can be specifically stated in the granting clause, but a security interest in collateral automatically extends to proceeds even if not mentioned (§9-102(a)(12)(A); §9-203(f); §9-315(a)(2)).
- **5. "Products"** can be specifically stated in the granting clause, but if goods become physically united and identification is lost, the security interest automatically extends to products even if not mentioned (§9-336).
- **6. "Insurance"** is excluded by section 9-109(d)(8), so unless such claims are proceeds of collateral, Article 9 is not applicable. A security interest can be granted in insurance, but such security interest would be governed by law other than Article 9 (e.g., common law).

# b. Example:

The Debtor hereby grants and pledges to the Secured Party, to secure the payment and performance in full of all of the Obligations, a security interest in all:

- a. accounts;
- b. chattel paper;
- c. Commercial Tort Claims (described on Schedule I hereto);
- d. Deposit Accounts;
- e. documents;
- f. general intangibles;
- g. goods;
- h. instruments;
- i. investment property;
- j. letter-of-credit rights;
- k. money;
- l. oil, gas, and other minerals before extraction;
- m. insurance and insurance claims;
- n. supporting obligations; and
- o. all other personal and fixture property, whether governed by Article 9 of the U.C.C. or other law wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof (collectively, the "Collateral").

Note: prior to extraction, oil, gas, and other minerals are treated as real property and as such lie outside the scope of Article 9. It is only upon extraction that such minerals become goods and subject to Article 9. See Official Comment 4c to section 9-102.

#### PERFECTION

**a. Overview:** To ensure perfection, it is crucial to correctly classify the collateral. Classification frequently depends on the debtor's use of the collateral. For example, a titled vehicle can be consumer goods if it is used primarily for personal, family, or household purposes; inventory if it is leased or held for sale or lease, or equipment if it is held for use. Perfection of a security interest in titled vehicles held for consumer use or as equipment is achieved by compliance with requirements administered by the governmental department responsible for registration and licensing of such vehicles, which commonly requires a notation of the lien on the certificate of title. If the titled vehicles are held for sale by a person in the business of selling goods of that kind, it is inventory, and perfection of a security interest therein is achieved by a properly filed financing statement.

# b. Example:

Following is a chart that indicates the various methods of perfection for most Article 9 collateral.

Type of Collateral	Automatic or Temporary	Possession	Control	Financing Statement
Accounts, general intangibles (except for sales of payment intangibles), described commercial tort claims				х
Instruments (except sales of promissory notes)	X	X		X
Goods, negotiable documents	X	X		X
Tangible chattel paper		Х		X
Investment property, electronic chattel paper			X	x
Certificated securities	X	Х	X	x
Deposit accounts, letter-of-credit rights			X	
Money		Х		
Payment intangibles (sales)	X			
Promissory notes (sales)	X			

- **c. Filing Overview:** Other than a security interest in sales of payment intangibles and promissory notes (where perfection is automatic), and deposit accounts, letter-of-credit rights and money, all security interests in personal property subject to Article 9 can be perfected by a properly filed financing statement. Authorization to file financing statements is automatic if the collateral description used in the financing statement is the same description provided in the security agreement. Specific authorization is required to file an "all assets" financing statement if collateral is less than all assets.
  - **1. Negotiable Provisions:** Fixtures are goods, and are therefore perfected by properly filing a financing statement centrally in the state where the debtor is located. However, the secured party may also request a "fixture filing" (§9-501(a)(2); Comment 4 to §9-501). Both filings perfect the security interest in fixtures. The significance of a fixture filing is that it will provide priority over any encumbrancer of the underlying land. *See* §9-334. Note, a duly recorded mortgage can be effective as a fixture filing if it

(among other things) indicates the goods, and the goods are, or are to become, fixtures. See §9-502(c). Since a fixture filing gives additional priority in the real property records, it is a negotiable requirement under a security agreement.

# 2. Example:

The Debtor hereby irrevocably authorizes the Secured Party at any time and from time to time to file in any Uniform Commercial Code jurisdiction financing statements (including amendments and continuations thereto) that: (a) indicate the Collateral (i) as all assets of the Debtor or words of similar effect, regardless of whether any particular asset comprised in the Collateral falls within the scope of Article 9 of the Uniform Commercial Code of the State or such jurisdiction, or (ii) as being of an equal or lesser scope or with greater detail; and (b) contain any other information required for the sufficiency or filing office acceptance of any financing statement or amendment, including (i) whether the Debtor is an organization, the type of organization, and any organization identification number issued to the Debtor (if required by the applicable jurisdiction) and, (ii) in the case of a financing statement filed as a fixture filing or indicating Collateral as as-extracted collateral or timber to be cut, a sufficient description of real property to which the Collateral relates. The Debtor agrees to furnish any such information to the Secured Party promptly upon the Secured Party's request. [The Debtor also ratifies its authorization for the Secured Party to have filed in any Uniform Commercial Code jurisdiction any like initial financing statements or amendments thereto if filed prior to the date hereof.]

- **d. Possession Overview:** Even though a security interest can be perfected in certain collateral by the proper filing of a financing statement, greater priority is afforded by taking possession of certain collateral (e.g., instruments, tangible chattel paper, certificated securities, negotiable documents).
  - 1. **Negotiable Provisions:** The requirement for possession of such collateral is negotiable, and may include thresholds for delivery (e.g., "value in excess of \$\_\_\_\_") or requirements for time of delivery (e.g., promptly, quarterly, upon default, after the continuance of an Event of Default).

# 2. Example:

If the Debtor shall at any time hold or acquire any promissory notes or tangible chattel paper in an amount in excess of \$\_\_\_\_\_ individually or \$ \_\_\_\_\_ in the aggregate, the Debtor shall endorse, assign, and deliver the same to the Secured Party on or before the first Quarterly Update Date following the acquisition thereof, accompanied by such instruments of transfer or assignment duly executed in blank as the Secured Party may from time to time specify.

**e. Control** — **Overview:** Whereas a security interest in letter-of-credit rights and deposit accounts can only be perfected by control, a security interest in other collateral can be perfected by the proper filing of a financing statement or control, and priority is afforded by obtaining control of such collateral (e.g., electronic chattel paper, investment property (including uncertificated securities) where the secured party may enter into a control agreement with the issuer or arrange for the uncertificated security to be registered

on the books of the issuer in the secured party's name), and certificated securities. Note that the secured party's security interest in financial assets (or deposit accounts or commodity accounts) perfected by control are superior to a security interest in financial assets (or deposit accounts or commodity accounts) claimed by another secured party as proceeds of other Article 9 collateral (§9-328(1)). However, the secured party's security interest will be junior to a security interest in favor of the securities intermediary (or depositary or commodity intermediary), unless the securities intermediary (or depositary or commodity intermediary) subordinates its security interest to the secured party's security interest (§9-328(3)).

**1. Negotiable Provisions:** Requirements regarding control are negotiable and may include thresholds for getting and exercising control, whether deposit accounts are excluded from the control requirement, timing to obtain control, and commercially reasonable efforts to obtain control. With respect to the latter, extension of time should be at the sole discretion of the collateral agent (if more than one secured party) to facilitate a quick response.

# 2. Example:

For each Deposit Account that the Debtor at any time opens or maintains, the Debtor shall, at the Secured Party's request and option, within 60 days of such request, such time to be extended in Secured Party's sole discretion, pursuant to an agreement in form and substance satisfactory to the Secured Party, either: (a) cause the depositary bank to agree to comply without further consent of the Debtor, with instructions from the Secured Party directing the disposition of funds from time to time credited to such Deposit Account; or (b) arrange for the Secured Party to become the sole customer of the depositary bank with respect to the Deposit Account, with the Debtor being permitted, only with the consent of the Secured Party, to exercise rights to withdraw funds from such Deposit Account. [The Secured Party agrees with the Debtor that the Secured Party shall not give any such instructions or withhold any withdrawal rights from the Debtor, unless an Event of Default has occurred and is continuing.] The provisions of this paragraph shall not apply to Excluded Deposit Accounts.

- **f. Collateral in the Possession of a Bailee Overview:** A security interest in possessory collateral perfected by a properly filed financing statement will lose priority to another secured party that takes possession of such collateral. *See*, *e.g.*, §9-328 (certificated securities); §9-330 (tangible chattel paper); §9-331 (negotiable chattel paper generally). To avoid this loss of priority, secured parties often require that the bailee acknowledge in an authenticated record that the bailee is holding such collateral for the benefit of the secured party. Such authenticated acknowledgment by the bailee will perfect the secured party's security interest by possession, thereby ensuring the priority of its security interest (§9-310(b)(6); §9-313).
  - **1. Negotiable Provisions:** A Debtor should never permit a third party to have the ability to put it in default. Therefore, this requirement should be negotiated with respect to whether commercially reasonable efforts are to be used to obtain bailee acknowledgement, the effects of failing to obtain such an acknowledgement (e.g., Event of Default or decrease in borrowing base) or whether the requirement is subject to a threshold based on the value of the collateral, individually or in the aggregate.

# 2. Example:

If any Possessory Collateral at any time is in the possession of a bailee, the Debtor shall promptly notify the Secured Party thereof and, at the Secured Party's request and option, shall promptly obtain an acknowledgement from the bailee, in form and substance satisfactory to the Secured Party, that the bailee holds such Collateral for the benefit of the Secured Party and such bailee's agreement to comply, without further consent of the Debtor, at any time with instructions of the Secured Party as to such Collateral. The Secured Party agrees with the Debtor that the Secured Party shall not give any such instructions unless an Event of Default has occurred and is continuing.

- g. Agreed Security Principles Overview: Agreed Security Principles are applicable to debtors organized under the laws of a jurisdiction outside of the United States, any state thereof, or the District of Columbia. Under some foreign laws, a guaranty and/or grant of a security interest may cause financial assistance laws or capitalization rules to become applicable and non-compliance may result in civil or criminal liability of officers and directors of the guarantor and/or Grantor. It may also be difficult to create a security interest in certain types of collateral, or it can take a long time and the documents may be different from U.S. security agreements.
- 1. **Negotiable Provisions:** Even if the debtor does not have any foreign subsidiaries or collateral located outside of the United States at the time of closing, the debtor could acquire a foreign subsidiary or move collateral outside of the United States after closing. Therefore, the debtor should always request the grant of a security interest be subject to the Agreed Security Principles.

## 2. Example:

(1) No lien or provision of a guarantee by any person organized outside the United States shall be made that would result in any breach of corporate benefit, financial assistance, capital preservation, fraudulent preference, thin capitalization rules, or any other law or regulation (or analogous restriction) of the jurisdiction of organization of such person, or result in any risk to the officers or directors of such person of a civil or criminal liability; (2) it is expressly acknowledged that in certain jurisdictions (a) it may be impossible or impractical (including for legal and regulatory reasons) to grant guarantees or create security over certain categories of assets in which event such guarantees will not be granted and security will not be taken over such assets or (b) it may take longer than agreed upon to grant guarantees or create security over certain categories of assets in which event the Collateral Agent will act reasonably in granting the necessary extension of timing for obtaining such guarantees or security, provided that in each case, with respect to subclauses (a) and (b), the relevant Guarantor has exercised due diligence and reasonable efforts in providing such guarantees or security; and (3) it is expressly acknowledged that the form of the Security Documents may vary from the forms attached to the Credit Agreement or Security Documents in order to conform to local requirements and customs as well as potential impracticality of complying with local requirements in respect of every item of collateral.

**h. Other Actions** — **Overview:** Article 9 generally precludes financing statements from perfecting a security interest in goods subject to state certificate of title statutes. Rather, perfection is achieved by compliance with the state's administering registration and licensing department, which commonly requires a notation of the lien on the certificate of title.

Similarly, if perfection of collateral is governed by U.S. treaties, statutes, or regulations, the filing of a financing statement may not be effective to perfect a security interest in such personal property. Examples of such collateral include registered copyrights, aircraft, rolling stock, and ship mortgages. Note that some courts have held that security interests in registered trademarks, even though governed by a federal registration system, are not perfected by filing with the PTO. *In re Together Development Corp.*, 227 B.R. 439 (Bankr. D. Mass. 1998). However, secured parties frequently require such filing because it may be necessary to defeat subsequent purchasers for value.

Security interests in personal property that are excluded from Article 9 (e.g., insurance policies) are perfected by complying with applicable state law other than Article 9.

Whereas perfection of a security interest in a government contract is achieved by a properly filed financing statement, enforcement of a security interest in such government contract can only be achieved if the debtor complies with the Federal Assignment of Claims Act of 1940 (FAOCA), 31 U.S.C. §3727 and 41 U.S.C. §15. Further assurance clauses imply future performance and help parties to a contract achieve their contractual purpose, even though not every required future action is identified therein. They are used by the secured party to require acts that are not included in the security agreement, but are necessary to achieve the objective of the security agreement (e.g., to grant and perfect a security interest in collateral and provide remedies if there is an Event of Default).

**1. Negotiable Provisions:** The requirement for a debtor to comply with state and federal perfection and enforcement laws is negotiable. It can be required, for example, only after the continuance of an Event of Default or only if the value of the personal property exceeds a certain amount.

## REPRESENTATIONS, WARRANTIES, AND COVENANTS CONCERNING THE DEBTOR

**a. Overview:** The representations and warranties confirm information that is necessary for the secured party to perfect its security interest by filing and to determine whether any earlier filings covering the same collateral exist. Perfection by filing is accomplished by filing a financing statement in the state in which the debtor is located, unless the collateral is timber to be cut or as-extracted collateral, or the financing statement is filed as a fixture filing and the applicable real estate is located in another state (§9-301). To file an effective financing statement and to search for other secured liens, among other things, the secured party needs the debtor's exact legal name and location. See §§9-503(a) and 9-506. For example, if the debtor is a registered organization organized under state law, as defined in section 9-102, the debtor will be located, for purposes of Article 9, in the state in which the debtor is organized. §9-307(e). If the debtor is a general partnership, the debtor will be located in the state in which it has its chief executive office (§9-307(b)(2)-(3)). That or like information (e.g., the debtor's mailing address, if different from the address of its chief executive office) is also required to be contained on the financing statement itself in order for the secured party to avoid the risk of the filing office rejecting the filing, or the risk of the secured security interest being

subordinated to a later secured party or purchaser that relies upon incorrect or missing information in the financing statement (§9-338; §9-516(b)(5)).

The debtor should covenant to provide to the secured party notice of the debtor's change of legal name, place of business (or chief executive office, if the debtor's location is so determined under section 9-307), type of organization (e.g., if the debtor's limited partnership converts to a limited liability company) or jurisdiction of organization (e.g., if the debtor reincorporates in another state). In these situations, the secured party may need to amend its financing statement or file a new financing statement in order to avoid the lapse of perfection or loss of priority of its security interest. See §9-316(a)(2) (change of debtor's location when the security interest had attached and was perfected at the time of the change); §9-316(a)(3) (a transferee of the collateral becoming a debtor, or a new debtor becoming bound by the security agreement, when the security interest had attached and was perfected at the time of the transfer of the new debtor becoming bound); §9-507(c) (change of debtor's name); and §9-508(a) (assets acquired by a new debtor after the new debtor is bound by another debtor's security agreement). A secured party generally has a minimum of four months from the date such a change is effective to continue the perfection of its security interest. Other changes in information reflected on the filed financing statement may not need to be amended for the secured party to preserve the perfection or priority of its security interest. See, e.g., §9-338 ("incorrect at the time the financing statement was filed") and §9-507(b). However, the secured party may wish to amend that information out of caution.

**b. Negotiable Provisions:** The requirements regarding certain changes are negotiable, including when the Perfection Certificate needs to be updated, whether a change in debtor's name, location, or type of organization is prohibited, or whether notice has to be given prior to such change or after such change. To maintain its perfected status in any attached security interst, a secured party has a minimum of four months to file or amend a financing statement if required, due to a change in, for example, the name or location of the debtor.

# c. Example:

The Debtor has previously delivered to the Secured Party a certificate signed by the Debtor and entitled "Perfection Certificate" (the "Perfection Certificate"). The Debtor represents and warrants to the Secured Party on the date hereof and on each Quarterly Update Date as follows: (a) the Debtor's exact legal name is that indicated on the Perfection Certificate and on the signature page hereof; (b) the Debtor is an organization of the type, and is organized in the jurisdiction, set forth in the Perfection Certificate; (c) the Perfection Certificate accurately sets forth the Debtor's organizational identification number or accurately states that the Debtor has none; (d) the Perfection Certificate accurately sets forth the Debtor's place of business or, if more than one, its chief executive office, as well as the Debtor's mailing address, if different; (e) all other information set forth on the Perfection Certificate pertaining to the Debtor is materially accurate and complete; and (f) other than as disclosed from time to time as required hereby, there has been no change in any of such information since the date on which the Perfection Certificate was signed by the Debtor.

The Debtor covenants with the Secured Party as follows: the Debtor shall provide notice to the Secured Party (i) on or before the earlier of the first Quarterly Update Date or 90 days after (a) changes to

Debtor's name and (b) changes to Debtor's type of organization, jurisdiction of organization, or other legal structure; and (ii) on or before the first Quarterly Update Date following changes to Debtor's organizational identification number (if it has one) or if it obtains an organizational identification number (if it does not yet have one).

# REPRESENTATIONS, WARRANTIES, AND COVENANTS CONCERNING THE COLLATERAL

**a. Overview:** The debtor typically represents and warrants to the secured party that: the debtor has sufficient rights in, or power to transfer rights in, the collateral for the secured party's security interest to attach (§9-203(b)(2)); the collateral is either not encumbered or, if encumbered, the encumbrances are permitted under the credit agreement ("Permitted Liens"); and the debtor will take all actions necessary to ensure continued perfection of the secured party's security interest in the collateral, including (if applicable) actions necessary to perfect a security interest in after-acquired collateral.

If any of the collateral constitutes "farm products," as defined in section 9-102(a)(34), the debtor should inform the secured party, so that the secured party can decide whether to take appropriate steps to obtain governmental consents under federal agricultural entitlement programs, to obtain waivers or subordinations from suppliers whose claims for unpaid purchase prices for agricultural supplies may have priority under federal law (e.g., the Packers and Stockyards Act of 1921, 7 U.S.C. §196, and the Perishable Agricultural Commodities Act of 1930, 7 U.S.C. §499e(c)), or to preserve its security interest, or the proceeds thereof, following the disposition of the farm product collateral under the Food Security Act of 1985, 7 U.S.C. §1631. If any of the accounts or other rights to payment comprised in the collateral are owned by governmental account debtors, the debtor should inform the secured party, and the secured party may wish to take steps under the FAOCA or any similar state statute to receive payments directly from the governmental account debtors.

The secured party may request a representation and warranty that the debtor has complied with labor and environmental laws where failure of the debtor to comply may result in a superior claim against, or interest in, the collateral. There is often an analogous representation and warranty in the credit agreement — the two should be drafted consistently. Similarly, other representations, warranties, and covenants may be covered in both documents, including those relating to insurance, inspection, books and records, and disposition of collateral. If covered in both the credit agreement and the security agreement, it is crucial that the provisions be the same.

Some security agreements include a representation and covenant that all subsidiaries that are limited partnerships and limited liability companies have opted into Article 8 of the U.C.C., so that all limited partnership interests and the limited liability company interests are Article 8 securities rather than general intangibles, thereby enabling the secured party to perfect by filing, possession and/or control, rather than perfecting only by filing (i.e., general intangibles can only be perfected by filing) (§9-310; §9-313(a); §9-314). This is because circumstances may change after closing that could affect the characterization of the collateral. A limited liability company's operating agreement may not, on the closing date, classify the membership interests as "Article 8 securities." If not so classified, the limited liability company will be a general intangible, and a financing statement filing is the only method of perfection. If, after the closing, the operating agreement is amended to provide that the membership interests are Article 8 securities, the secured party

will be at risk that a subsequent secured party will take a security interest in the membership interests and perfect the security interest by taking "control." It is preferable to perfect by obtaining "control" because a security interest perfected by control will have priority over a security interest perfected by filing (even when the secured party perfecting by control is aware of the existing security interest perfected by filing) (§9-328(1)). Perfection by control varies depending upon the type of security involved, but the three general methods are: (a) becoming the registered owner of the security, (b) taking physical possession of the security with all necessary endorsements (e.g., stock power, bond power), or (c) in the case of an uncertificated security or an account at a brokerage firm, getting a "control" agreement signed by the owner of the security, the issuer of the security (or, in the case of a brokerage firm, the brokerage firm) and the secured party in which the issuer of the security (or the brokerage firm) agrees to follow the instructions of the secured party with regard to the disposition of the security (or securities in the account) without further consent of the owner of the security (or the securities in the account). See §9-106; §8-106.

**b. Negotiable Provisions:** Requirements regarding representations and warranties are negotiable and may be negotiated with respect to whether they are always true, whether they are true on funding dates, and when they need to be updated. Rather than opting into Article 8, the debtor can covenant not to opt into it during the term of the loan. It is in debtor's best interest to keep the representations, warranties, and covenants limited to perfecting a security interest in the collateral and avoid provisions that deal with the quality of the collateral and the maintenance of the collateral. Debtors will want quality of collateral provisions limited by phrases such as "to the extent reasonably likely to cause a material adverse effect" and maintenance of collateral provisions limited by phrases such as "in debtor's prudent business judgment to be decided in good faith."

## c. Example:

The Debtor further represents and warrants to the Secured Party as follows: (a) the Debtor is the owner of [or has other rights in or power to transfer rights in] the Collateral, free from any right or claim of any person or any adverse lien, security interest or other encumbrance, except for the security interest created by this Agreement [and Permitted Liens]; (b) [other than as disclosed on the Quarterly Update Dates,] none of the Collateral constitutes, or is the proceeds of, "farm products" as defined in §9-102(a) of the Uniform Commercial Code of the State; (c) [except for (describe) and other than as disclosed on the Quarterly Update Dates,] none of the account debtors or other persons obligated on any of the Collateral is a governmental authority owing in excess of \$\_\_\_\_\_ annually, covered by the FAOCA or like federal, state or local statute or rule in respect of such Collateral; (d) the Debtor holds no Commercial Tort Claims except as indicated on the Perfection Certificate and [other than as disclosed on the Quarterly Update Dates; (e) the Debtor has at all times operated its business in compliance with laws to the extent required by Section of the Credit Agreement; (f) all other information set forth on the Perfection Certificate pertaining to the Collateral is materially accurate and complete; [and] (g) there has been no change in any of such information since the date on which the Perfection Certificate was signed by the Debtor other than as disclosed [; and (h) the Memorandum of Grant of Security Interest in Copyrights identifies all now existing material registered copyrights and other rights in and to all material registered copyrightable works of the Debtor, identified, where applicable, by title, author and/or Copyright Office registration number and date].

The Debtor further covenants with the Secured Party as follows: (a) other than in the ordinary course of business, the Collateral, to the extent not delivered to the Lender pursuant to Section \_\_\_, will be kept at those locations listed on the Perfection Certificate and the Debtor will not remove a material portion of the Collateral from such locations, without providing at least 30 days' prior written notice to the Secured Party; (b) except for the security interest herein granted [and Permitted Liens], the Debtor shall be the owner of [or have other rights in] the Collateral free from any right or claim of any other person or any lien, security interest, or other encumbrance, and the Debtor shall defend the Collateral against all claims and demands of all persons at any time claiming the Collateral or any interests therein materially adverse to the Secured Party; (c) the Debtor shall not pledge, mortgage or create, or suffer to exist, any right of any person in or claim by any person to the Collateral, or any security interest, lien, or other encumbrance in the Collateral in favor of any person, or become bound (as provided in section 9-203(d) of the Uniform Commercial Code of the State or any other relevant jurisdiction or otherwise) by a Security Agreement in favor of any person as Secured Party, other than the Secured Party [and Permitted Liens]; (d) to the extent deemed prudent business conduct (to be determined by the Debtor in its good faith discretion), the Debtor will keep the Collateral in good order and repair; (e) [as provided in the Credit Agreement, the Debtor will permit the Secured Party, or its designee, to inspect the Collateral at any reasonable time, wherever located; (f) [except as otherwise provided in the Credit Agreement,] the Debtor will pay promptly when due all taxes, assessments, governmental charges and levies upon the Collateral or incurred in connection with the use or operation of such Collateral or incurred in connection with this Agreement; (g) the Debtor will continue to operate its business in compliance with all laws as required by Section of the Credit Agreement; (h) other than in the ordinary course of business, the Debtor will not sell or otherwise dispose of, or offer to sell or otherwise dispose of, the Collateral or any interest therein [except as permitted by the Credit Agreement] [if an Event of Default has occurred and is continuing] [except sales or other dispositions of equipment consistent with prudent business practices [; and (i) on or before the first Quarterly Update Date following the Debtor's acquisition thereof, to provide to the Secured Party like identifications of all material registered copyrights and other rights in and to all material registered copyrightable works hereafter acquired by the Debtor, and to execute and deliver to the Secured Party a supplemental Memorandum of Grant of Security Interest in Copyrights, in form and substance satisfactory to the Secured Party, modified to reflect such subsequent acquisitions and registrations].

## EXPENSES INCURRED BY THE SECURED PARTY

- **a. Overview:** If the secured party incurs expenses to protect the collateral (e.g., cost of repairs, filing fees, insurance premiums), such expenses usually are added to the debt and secured by the collateral. Interest on these expenses usually is also included, because such expenses are considered an involuntary advance. Reasonable expenses incurred by the secured party to protect the collateral are almost always paid for by the debtor in secured transactions.
- **b. Negotiable Provisions:** Parties frequently negotiate whether such expenses must be reasonable and documented.

# RIGHTS OF SECURED PARTY PURSUANT TO SECTION 9-207(c)(3)

- **a. Overview:** The secured party has the right pursuant to section 9-207(c)(3) to create a security interest for the benefit of its lenders in any collateral in its possession or control pursuant to sections 9-104, 9-105, 9-106, or 9-107.
- **b. Negotiable Provisions:** To avoid the risk of losing ownership of a debtor's subsidiary (or other consequences), the debtor should get the secured party to waive its rights under section 9-207(c)(3). Note that if there is more than one secured party and a collateral agent has possession or control pursuant to sections 9-104, 9-105, 9-106 or 9-107, there is no need to get such a waiver because the collateral agent must hold such collateral for the benefit of the secured parties.

## REMEDIES AND STANDARDS FOR EXERCISING REMEDIES

- a. Overview: The secured party's rights upon the debtor's default are generally set forth in Part 6 of Article 9, which gives three types of rights:
- Rights provided for in the security agreement;
- Rights provided for in Part 6 of Article 9 (including collecting or obtaining performance from third parties, foreclosure, and strict foreclosure); and
- Judicial procedures (but it is often helpful, especially in the case of non-Article 9 personal property collateral, for the debtor to acknowledge in the security agreement the rights of the secured party).

The secured party, in turn, owes various duties to the debtor. See §9-602. Many of these duties may not be waived by the debtor, in the security agreement or otherwise, or may be waived by the debtor only after default.

Many security agreements set forth a period of time which the parties agree to be "reasonable" to provide the debtor advance notice of the disposition of collateral by the secured party (§9-612(a)). Article 9 provides a "safe harbor" such that 10 days' prior notice is per se reasonable in a transaction in which the debtor is not a consumer (§9-612(b)).

Although many of the secured party's duties to the debtor may not be waived by the debtor in the security agreement or otherwise, or may be waived by the debtor only after default, there is no reason why the parties may not agree in the security agreement to "not manifestly unreasonable" standards for the secured party to fulfill those duties. See §9-603. Such standards may include setting forth the publications in which advertising of a public disposition of the collateral should be placed, the identity and bidders to be solicited in a private sale, or particular markets in which collateral dispositions should be made. If the secured party has determined a "reasonably convenient" location where, after default, the debtor should assemble the collateral and make it available to the secured party, and that determination is not "manifestly unreasonable," the location may be set forth in the security agreement. See §9-603(a); §9-609(c). When reviewing such provisions, debtor's counsel needs to be cognizant of the enforceability opinion that the secured party will likely require as a condition of closing.

After default, there are three general remedies which may be exercised. It is best practice for the secured party to accelerate the loan before exercising any remedies to ensure that the default covers all of the secured obligations.

## 1. Sell the collateral.

Section 9-610 permits the secured party to sell, lease, license, or otherwise dispose of any or all of the collateral in its present condition or following any commercially reasonable preparation or processing. Every aspect of the sale must be commercially reasonable. Failure to sell the collateral in a commercially reasonable manner will adversely affect the ability of the secured party to collect any deficiency and will expose the secured party to damages (§9-625; §9-626).

The sale can be accomplished through a public disposition or a private disposition. Article 9 does not define the term "public disposition," but the Official Comments indicate that it is one at which the price is determined after the public has had a meaningful opportunity for competitive bidding. "Meaningful opportunity," according to the Comments, is meant to imply that some form of advertisement or public notice must precede the sale or other disposition, and that the public must have access to the sale or disposition (comment 7 to §9-6100).

The secured party cannot purchase the collateral at a private disposition unless the collateral is of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations. *See* Comment 7 to §9-610(c).

## 2. Negotiate a partial or full strict foreclosure with the debtor after default.

Section 9-620 provides a procedure in which the debtor and secured party can agree to transfer some or all of the collateral to the secured party in satisfaction of some or all of the obligations secured by the collateral.

There is a procedure that must be followed, and the rules are technical. The procedure requires an agreement after default to accept the collateral and notice given of the transaction to persons having a security interest in the collateral (who can block the transaction). If the transaction is completed, the transaction transfers title to the secured party and discharges any subordinate liens. §9-622. However, section 1-304 imposes an obligation of good faith on the secured party in enforcing its rights, and this obligation cannot be disclaimed. *See also* §1-302. Comment 11 to section 9-620 states that a proposal and acceptance made under section 9-620 in bad faith (e.g., accepting \$1 million of collateral for a \$10 debt) would not be effective.

Potential pitfalls when foreclosing on limited liability and partnership interests include:

- Transfer restrictions;
- Absence of the right to cause the admission of the purchaser as a partner/member;
- Capital contribution obligations that may be imposed on the new partner/member;

- Illiquidity (purchaser may not have a right to distributions or to resell);
- Securities law considerations in conducting a sale; and
- Lack of limited liability if this is a general partnership or general partnership interest as collateral if formalities are not observed.

# 3. Collect from third parties after default.

If the collateral consists of rights to payment or performance by third parties, the secured party may collect from, or obtain performance by, the third parties. Note that if the third party obligor is paying the debtor in installments this can take a long time. Secured parties can exercise their control and sweep all funds from controlled deposit accounts and financial assets from controlled securities accounts. See §9-607.

Typically, the security agreement will provide that after the occurrence and continuance of an Event of Default, a secured party may:

- Accelerate the payment of the Obligations "without further notice or demand on the debtor"; and
- Have the right to take possession of the collateral in any jurisdiction in which enforcement is sought, in addition to all rights and remedies of a secured party under the U.C.C. of the State or any other relevant jurisdiction, and any additional rights and remedies as may be provided by applicable law.

As noted, Article 9 provides 10 days' notice of sale as a safe harbor for notice requirements. Therefore, the security agreement typically provides for 10 days' notice. The security agreement may also indicate what is agreed to be commercially reasonable (e.g., regarding advertising, notice, location of sale).

**b. Negotiable Provisions:** To the extent the Remedies section of the security agreement conforms to Part 6 of Article 9, this section is minimally negotiated. However, make certain that all provisions are in compliance with Article 9; for example, don't permit the waiver of any rights that are not waivable under Article 9. See §9-602.

# c. Example:

After an Event of Default has occurred and is continuing, the Secured Party shall, without any other notice to or demand upon the Debtor, thereafter have in any jurisdiction in which enforcement hereof is sought, in addition to all other rights and remedies, the rights and remedies of a secured party under the Uniform Commercial Code of the State or any other relevant jurisdiction and any additional rights and remedies as may be provided by applicable law, including the right to take possession of the Collateral, and for that purpose the Secured Party may, so far as the Debtor can give authority therefor, enter upon any premises on which the Collateral may be situated and remove the same therefrom. The Secured Party may in its discretion require the Debtor to assemble all or any part of the Collateral at such location or locations within the jurisdiction(s) of the Debtor's principal office(s) or at such other locations as the Secured Party may reasonably designate. Unless the Collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, the Secured Party shall give

to the Debtor at least ten (10) days' prior written notice of the time and place of any public sale of Collateral or of the time after which any private sale or any other intended disposition is to be made. The Debtor hereby acknowledges that ten (10) days' prior written notice of such sale or sales shall be reasonable notice. In addition, the Debtor waives any and all rights that it may have to a judicial hearing in advance of the enforcement of any of the Secured Party's rights and remedies hereunder, including, without limitation, the Secured Party's right after an Event of Default has occurred and is continuing, to take immediate possession of the Collateral and to exercise its rights and remedies with respect thereto.

To the extent that applicable law imposes duties on the Secured Party to exercise remedies in a commercially reasonable manner, the Debtor acknowledges and agrees that it is not commercially unreasonable for the Secured Party: (a) to fail to incur expenses reasonably deemed significant by the Secured Party to prepare Collateral for disposition or otherwise to complete raw material or work in process into finished goods or other finished products for disposition; (b) to fail to obtain third-party consents for access to Collateral to be disposed of, if not required by other law; (c) to fail to obtain governmental or third-party consents for the collection or disposition of Collateral to be collected or disposed of; (d) to fail to exercise collection remedies against account debtors or other persons obligated on Collateral or to remove liens or encumbrances on or any adverse claims against Collateral; (e) to exercise collection remedies against account debtors and other persons obligated on Collateral directly or through the use of collection agencies and other collection specialists; (f) to advertise dispositions of Collateral through publications or media of general circulation, whether or not the Collateral is of a specialized nature; (g) to contact other persons, whether or not in the same business as the Debtor, for expressions of interest in acquiring all or any portion of the Collateral; (h) to hire one or more professional auctioneers to assist in the disposition of Collateral, whether or not the Collateral is of a specialized nature; (i) to dispose of Collateral by utilizing Internet sites that provide for the auction of assets of the types included in the Collateral or that have the reasonable capability of doing so, or that match buyers and sellers of assets; (j) to dispose of assets in wholesale rather than retail markets; (k) to disclaim disposition warranties; (l) to purchase insurance or credit enhancements to insure the Secured Party against risks of loss, collection or disposition of Collateral or to provide to the Secured Party a guaranteed return from the collection or disposition of Collateral; or (m) to the extent deemed appropriate by the Secured Party, to obtain the services of brokers, investment bankers, consultants and other professionals to assist the Secured Party in the collection or disposition of any of the Collateral. [Specify other standards applicable to any specific type of Collateral.] The Debtor acknowledges that the purpose of this Section is to provide nonexhaustive indications of what actions or omissions by the Secured Party would not be commercially unreasonable in the Secured Party's exercise of remedies against the Collateral and that other actions or omissions by the Secured Party shall not be deemed commercially unreasonable solely on account of not being indicated in this Section. Without limitation upon the foregoing, nothing contained in this Section shall be construed to grant any rights to the Debtor or to impose any duties on the Secured Party that would not have been granted or imposed by this Agreement or by applicable law in the absence of this Section.

#### SURETYSHIP WAIVERS

Waiver of notice of loans made, extensions of due dates, failure to perfect, and release of collateral are relevant only if the debtor is not the borrower (e.g., if debtor is granting a security interest in its assets to secure a loan to its subsidiary).

#### NOTICES

The U.C.C. distinguishes the act of giving notice from the receipt of notice. Such notice provisions allocate risks depending on whether the notice is deemed given upon delivery or upon receipt. Some of the provisions to consider include whether notice has to be in writing or can be oral, whether notice must be signed by a certain party, or received by a certain party, and how notice has to be delivered (email, fax, first class mail, registered mail, certified mail, overnight carrier), who must receive the notice, and whether the recipient must sign a receipt.

#### CONFLICTS

If there is an intercreditor agreement, it should always control if there is a conflict between the security agreement and the intercreditor agreement.

#### POST-CLOSING

- a. Overview: Frequently, conditions precedent to closing, for example, requirements for delivery of control agreements and landlord waivers, are modified to become post-closing requirements to avoid extended delays in closing.
- **b. Negotiable Provisions:** Certain provisions are crucial for debtors, including giving the collateral agent the sole discretion to extend such time period to satisfy such post-closing requirements if there is more than one secured party. In addition, debtors do not want to risk allowing third parties the power to put them in default. Thus, debtors should try to obtain a Commercially Reasonable Efforts standard for delivery of post-closing requirements.

#### **TERMINATION**

**a. Overview:** Liens should automatically be released upon payment in full of the Obligations and termination of the commitment to extend credit. Exceptions include letters of credit that get cash collateralized rather than terminated and indemnities that survive the termination of the credit agreement. Note that in the case of consumer goods, a secured party has an affirmative duty to file a termination statement. In nonconsumer goods contexts, if the secured party does not terminate or authorize the termination of financing statements within 20 days after it receives an authenticated demand from the debtor, the debtor may file the termination statement if the termination statement indicates the debtor authorized such filing. See Comment 6 to §§9-509 and 9-513(c).

# b. Example:

Upon the indefeasible payment in full of the Obligations that are due and payable, including the cash collateralization, expiration, or cancellation of all Obligations, if any, consisting of letters of credit, and the full and final termination of any commitment to extend any financial accommodations under the Credit Agreement, the security interests granted herein shall automatically terminate and all rights to the Collateral shall revert to Debtor. Upon any such termination, Secured Party will, at Debtor's expense, execute and deliver to Debtor such documents as Debtor shall reasonably request to evidence such termination. Such documents shall be prepared by Debtor and shall be in form and substance reasonably satisfactory to Secured Party.

## **CHOICE OF LAW PROVISIONS**

## a. Overview:

- **1. Governing Law:** Article 9 provides the rules for determining what law governs perfection because third parties need certainty in where to look to obtain notice of a lien. The parties to a security agreement (with certain exceptions) cannot pick the law that governs perfection.
- **2. General Rules for Law Governing Perfection:** In general, the law of the jurisdiction in which the debtor is "located" will govern the perfection of security interests by filing (§9-301). Section 9-307 outlines the determination of where a debtor is "located":
  - Individuals are located in the jurisdiction of the location of their principal residence (§9-307(b) (1)). It may be difficult to determine a debtor's principal residence if the debtor has more than one residence. If representing the secured party, it is best to file in all jurisdictions where the debtor has a residence, driver's license, voting card, or state identification card;
  - Registered organizations organized under state law are located in the state under the laws of which they are organized (§9-307(e)). Not every entity organized under state law is a "registered organization." Generally, these entities include corporations, limited liability companies, limited partnerships, and other entities that are organized solely under the law of a single state and for which the state must maintain a public record showing that the entity has been organized (§9-102(a)(70)). General partnerships typically do not meet this definition. Registered organizations organized under federal law may be located, variously, in the state designated by federal law, in the state designated as its location, or in the District of Columbia (§9-307(f));
  - Foreign entities are located in the jurisdiction of the location of their place of business (or chief executive office, if the entity has more than one place of business), if such location is in a jurisdiction whose law generally requires information concerning the existence of a nonpossessory security interest to be made generally available in a filing, recording, or registration system as a condition to the security interest obtaining priority over the rights of other lien creditors (a notice filing system similar to Article 9). If the location is not in a jurisdiction with a notice filing system similar to ours, the debtor is deemed located in the District of Columbia (§9-307(b)-(c)).

If the foreign jurisdiction has not adopted Article 9 or a previous version of Article 9 it is safest to file with the District of Columbia and retain foreign counsel to perfect the security interest under foreign law; and

- "Fallback Rule"/Other entities (e.g., general partnerships): Organizations are located in the jurisdiction of the location of their place of business; organizations with more than one place of business are located in the location of their chief executive office.
- **3. Special Rules Bank Accounts:** The law of the depository institution's "jurisdiction" governs the perfection of a security interest in a deposit account maintained by the debtor with that bank (§9-304(a)). Although there are several rules to determine this, the parties (i.e., the bank and the debtor) can pick the "jurisdiction" for purposes of section 9-304(b). As noted below, the only method by which to perfect a security interest in a bank deposit account is by obtaining "control" of that account. Typically this will be accomplished through an "account control agreement" among the debtor, the secured party and the depository institution or it is accomplished automatically if the secured party is the depository institution. The account control agreement should state the law that governs perfection.
- **4. Perfection by Possession:** The law of the jurisdiction where the collateral is located governs the perfection of collateral that is perfected by possession.

## **GOVERNING LAW AND FORUM DESIGNATION CLAUSES**

**a. Overview:** Most contracts designate a particular state's law to govern the contractual relationship and provide for application of such law in resolving disputes that arise out of such contracts, including whether the security interest has attached and the rights of enforcement. Such governing law provisions provide a degree of predictability of how the contract will be interpreted and how disputes will be resolved. The designated state should bear some relationship to the contract (e.g., where parties conduct business, where contract was negotiated, where performance occurs). If there is no such relationship, there is a risk that such governing law provision will be unenforceable.

The forum designation clause works together with the governing law provision to maximize the predictability of interpreting contractual provisions and resolving disputes. The forum does not need to be the same as the state of the designated governing law (though it is preferable to ensure that a court is interpreting its own state's laws rather than the law of another state). The forum designation may be exclusive or non-exclusive:

- Exclusive the action may be brought only in that jurisdiction. This must be expressed as clearly as possible. In such circumstances a party can enjoin the opposing party from litigating elsewhere;
- Non-exclusive serves only as a consent to jurisdiction in a particular forum. An action may be commenced elsewhere.

## b. Examples:

## **Example 1: Exclusive Forum Designation**

Forum Designation. Any action or proceeding against any of the parties hereto relating in any way to this Agreement or the subject matter hereof shall be brought and enforced exclusively in the competent

courts of New York, and the parties hereto consent to the exclusive jurisdiction of such courts in respect of such action or proceeding.

# **Example 2: Exclusive Forum Designation**

Designation of Forum. Any suit brought by either party against the other party for claims arising out of this Agreement shall be brought in the United States District Court for the Southern District of New York, or in the event that court lacks jurisdiction to hear the claim, in New York State Supreme Court for New York County.

# **Example 3: Non-exclusive Forum Designation**

Forum Designation; Submission to Jurisdiction. (i) The Debtor agrees that any legal action or proceeding with respect to this Agreement or the transactions contemplated hereby may be brought in any court of the State of New York, or in any court of the United States of America sitting in New York, and the Debtor hereby submits to and accepts generally and unconditionally the jurisdiction of those courts with respect to its respective person and property and irrevocably consents to the service of process in connection with any such action or proceeding by personal delivery to the Debtor or by the mailing thereof by registered or certified mail, postage prepaid to the Debtor, at the address for the Debtor. (ii) Nothing in this paragraph shall affect the right of the Debtor to serve process in any other manner permitted by law or limit the rights of any party or person to bring any such action or proceeding against the Debtor or property in the courts of any other jurisdiction. The Debtor hereby irrevocably waives any objection to the laying of venue of any such suit or proceeding in the above described courts.

## **Example 4: Non-exclusive Forum Designation**

Forum Designation; Submission to Jurisdiction. This Agreement and the documents referred to herein shall be governed by, and construed in accordance with, the law of the State of New York. Each Party hereto hereby submits to the non-exclusive jurisdiction of the United States District Court for the Southern District of New York and of any New York state court sitting in New York City for the purposes of all legal proceedings arising out of or relating to this Agreement or the transactions contemplated hereby. Each party hereto irrevocably waives, to the fullest extent permitted by applicable law, any objection which it may now or hereafter have to the laying of the venue of any such proceeding brought in such a court and any claim that any such proceeding brought in such a court has been brought in an inconvenient forum.

## **Example 5: Submission to Jurisdiction**

Submission to Jurisdiction. (i) For the purposes of this Agreement, each party irrevocably submits to the jurisdiction of any court in \_\_\_\_\_\_ or any courts of the United States of America located in New York and each party hereby agrees that all suits, actions, and proceedings brought by such party hereunder shall be brought only in any court in \_\_\_\_\_ and courts of the United States of America located in New York. (ii) Each party irrevocably waives, to the fullest extent permitted by law, any objection which it may now or hereafter have to the laying of the venue of any such suit, action, or proceeding brought in such a court has been brought in an inconvenient forum, and the right to object, with respect to any such suit, action, or proceeding brought in any such court, that such court does not have jurisdiction over such party or the other party. (iii) In any such suit, action, or proceeding, each party waives, to the

fullest extent it may effectively do so, personal service of any summons, complaint, or other process and agrees that the service thereof may be made by certified or registered mail accompanied by first class prepaid ordinary postage, addressed to such party at its address. (iv) Each party agrees that a final nonappealable judgment in any such suit, action, or proceeding brought in such a court shall be conclusive and binding.

# WAIVER OF JURY-TRIAL PROVISIONS

- a. Waiver of Jury-Trial Provisions in New York: In Barclays Bank of New York v. Heady Electric Co., 571 N.Y.S.2d 650, 652 (N.Y. App. Div. 1991), the court held that "contract provisions waiving a jury trial are valid and enforceable, unless an adequate basis to deny enforcement is set forth by the challenging party." The leading federal case in New York discussing this issue is Morgan Guaranty Trust Co. of New York v. Crane, 36 F. Supp. 2d 602 (S.D.N.Y. 1999). The court held that the parties to a contract may, by prior written agreement entered into knowingly and voluntarily, waive the right to a jury trial. The Morgan Guaranty court applied a four-factor test in determining whether a contractual waiver of a right to jury trial was entered into knowingly and voluntarily. Id. at 603-04. Once the test had been met, the waiver was deemed to be enforceable. The four factors include:
- The negotiability of contract terms and negotiation between the parties concerning the waiver provision;
- The conspicuousness of the waiver provision in the contract;
- The relative bargaining power of the parties; and
- The business acumen of the party opposing the waiver.
- b. Waiver of Jury-Trial Provisions in Delaware: In Tracinda Corp. v. DaimlerChrysler AG, 2003 WL 22769051 at \*2 (D. Del. Nov. 19, 2003), aff'd, 502 F.3d 212 (3d Cir. 2007), the Delaware Chancery Court discussed the enforceability of a broadly worded jury trial waiver clause contained in a Stockholder Agreement. As in Morgan Guaranty, the Tracinda Corp. court set forth four factors in determining whether a contract effectively provides for a waiver of jury trial which include:
- The negotiability of the contract terms;
- Any disparity in bargaining power between the parties;
- The business acumen of the party opposing the waiver; and
- The conspicuousness of the jury-waiver provision.
- c. Waiver of Jury-Trial Provisions in General: In addition to the general standards examining the enforceability of a contractual jury trial waiver, there are other courts' holdings regarding the enforceability of the jury trial waivers which are worth noting. New York courts have held that "unless a party alleges that its agreement to waive its right to a jury trial was itself induced by fraud, the party's contractual waiver is enforceable vis-à-vis an allegation of fraudulent inducement relating to the contract as a whole." Merrill Lynch & Co. v. Allegheny Energy, Inc., 500 F.3d 171, 188 (2d Cir. 2007). Courts have also held that a jury trial waiver provision in a contract affects only the rights of the parties to that contract, rather than any other parties who did not execute the agreement in their own personal capacity. See, e.g., Hulsey v. West, 966 F.2d 579, 581-82 (10th Cir. 1992) (holding that the guarantor of a corporate loan was not bound by the jury waiver provision). Moreover, depending on the specific contract language used in the jury trial waiver provision, courts have held that some actions may not fall within the scope of the waiver. For example, in In re

Oakwood Homes Corp., 378 B.R. 59 (Bankr. D. Del. 2007), the provision at issue purported to waive any right to a jury trial in any action "relating directly or indirectly" to the agreement. The court held that the provision was unenforceable as to the party's breach of broader duties that did not arise from the contract. See also Nichols Motorcycle Supply Inc. v. Dunlop Tire Corp., 913 F. Supp. 1088 (N.D. Ill. 1995) (holding that a broad jury waiver in a Distributor Agreement did not encompass any claims that do not directly arise in the Distributor Agreement).

## **INDEMNIFICATION**

- **a. Overview:** An indemnification clause limits a party's liability or loss. The indemnification clause typically states that one party (the indemnitor) will reimburse another party (the indemnitee) for "all claims, demands, losses, expenses, damages, and causes of action asserted by any person or entity arising out of, caused by or relating to the Security Agreement and the Collateral and suffered by the indemnitee." In New York, it is well established that, in most cases involving commercial contracts negotiated by sophisticated parties, indemnification clauses will be given the deference accorded freely negotiated contracts. In Delaware, the approach is even more deferential to the terms of the clause. Security agreements typically contain clauses in which the debtor agrees to indemnify the secured party for liabilities and losses other than liabilities and losses caused by the secured party's gross negligence or willful misconduct.
- **b. Negotiable Provisions:** Whether the indemnity will cover agents of the secured party and employees of the secured party can be negotiated. Also consider whether it is an indemnity against "liability" or "loss." An indemnity against liability requires payment by the indemnitor when the indemnitee becomes liable. An indemnity against loss requires that the indemnitee first suffer loss (i.e., that the indemnitee pay the injured person before recovering from the indemnitor). Although not common in security agreements, in certain circumstances consideration should be given to providing for notice of pending claims, control of litigation, payment of expenses, control of litigation costs, limitation on the number of counsel, and who chooses counsel.

#### CONCLUSION

There is really no such thing as "security agreement boilerplate." All provisions in a security agreement are negotiated to achieve the goals of the parties thereto. The resulting agreement reflects the power struggle between the parties. If a debtor has a good credit rating, it will obtain a more favorable security agreement. It is all a matter of allocating risks.

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