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This article makes an attempt to reduce the broad and diverse subject matter of secured lending into some of its simplest common denominators and, from these, to develop some practical guidelines that can be applied to most secured transactions. The following topic will be discussed at some length: loans secured by inventory, accounts receivable, and stocks, bonds and similar collateral. Loans secured by cash value of life insurance, petroleum, ship mortgages and aircraft will be discussed briefly.

Before we begin our discussion on secured lending, perhaps it is appropriate to examine *Webster's* definition of collateral: "related to but not strictly a part of the main thing or matter under consideration." In terms of banking, it is obvious that the "main thing or matter under consideration" is the loan, and the collateral is that which is "related to" it. A good lending policy and strict adherence to the fundamentals of credit foster sound loans, and collateral is an inept substitute for either. While space permits only a cursory examination of lending policy and the basics of credit, any discussion of lending that fails to consider these essentials would be fruitless.

Prudence in lending requires critical self-examination. A wise lender knows his own limitations, seeks advice when necessary, and seldom makes the same mistake twice. Lending policy should evolve only after careful consideration has been given to the bank's management, organization, trade area, objectives, history, markets, lending personnel, loan portfolio, experience in various fields, areas of expertise and problem areas. The product of these considerations should be guidelines which promote sound loans and eliminate unnecessary risks. Some key elements relating to secured lending which should be covered by loan policy are:

(1) types of collateral considered desirable and undesirable;
(2) margin requirements for different types of collateral;
(3) term of loans for each type of collateral;
(4) interest rate;
(5) method of determining and documenting the value of collateral;

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(6) documentation standards;
(7) procedures for handling each type of loan.

We have all been exposed to the old axiom, "Collateral cannot make a bad loan good, but it can make a good loan better." Adherence to the basics of credit is the best way to ensure that the lender starts first with a good loan. A few moments analyzing the following questions often reveal an unsound loan:

(1) Are the borrower's character, reputation and ability satisfactory?
(2) What is the purpose of the loan?
(3) Will the loan benefit both the borrower and the lender?
(4) How, when, and from what source will the loan be repaid?
(5) Is the capital of the borrower adequate?
(6) Is the loan practical, considering the above questions and all of the other factors which must be considered?

Admittedly, secured lending came about partly in recognition of the fact that some borrowers fail to meet all of the criteria necessary for unsecured financing. The tool of secured lending can be effectively used to compensate to a certain extent for deficiencies, such as temporary shortages of working capital or inadequate capital. It can never serve as a substitute for character and ability. A secured loan should never be made to permit a borrower to acquire collateral if selling the collateral is the only source of repayment.

Risk is inherent in lending, and a banker's ability to recognize and deal effectively with it is the essence of lending. Secured lending, then, should serve as a vehicle to enable us to reduce risks to an acceptable level so that banks can better fulfill their responsibilities to their customers, communities, shareholders and employees. The reduction of risks to an acceptable level is the principal function of collateral. When a secured loan is properly handled, collateral values should always exceed loan balances so that the lender never loses the option of liquidating collateral if necessary. In theory, this seems quite simple, but experience soon proves that it is easier said than done. A logical and systematic approach to each secured transaction, however, can assist the lender in minimizing the risks associated with secured lending. One approach is to divide each secured transaction into four phases. First, the value of the collateral should be established and the proper margin determined. Second, the lender should control and evaluate the collateral throughout the life of the credit. Third, he must perfect a security interest in the collateral. Last, but most important, he must review the overall credit on a regular basis.

Let us take a moment to discuss these four areas. Establishing the value of certain types of collateral can, in itself, be a very difficult process; in fact, it is impossible in some cases. For instance, what is the value of a specialized electronic component, an inventory represented by a new product not yet marketed, or a disputed account receivable? The term "value," for purpose of this discussion, means the dollar amount the *lender* would receive upon liquidating the collateral within a reasonable period of time. There is a definite distinction between the lender's selling collateral under a situation of distress and the borrower's selling collateral under ordinary circumstances. One should also bear in mind that, while some items have value, their marketability is limited and it may take years to dispose of them. If the value of the collateral cannot be established, the safest course is to decline the extension of credit or look for an alternate method of handling the loan. If collateral values can be established with a reasonable degree of accuracy, the question of a proper margin must be addressed. A proper margin should protect the lender from possible fluctuations in collateral values, from the lower price that will normally prevail in a liquidation situation and from carrying costs, selling expenses, attorney's fees and other contingencies.

The process of controlling and evaluating collateral over a period of time depends upon the type of collateral. Each presents its own peculiar, and often interesting, problems to be dealt with by the lender. The objective is to know at all times how much collateral exists, its location, and its value. Since each type of collateral requires its own consideration, this subject will be discussed in connection with each specific form.

The Uniform Commercial Code, which is now in effect in all states except Louisiana, has gone a long way toward simiplifying the legal aspects of most secured transactions. But the codes enacted by the various states differ in some respects, and as of July, 1976, sixteen states had adopted the 1972 Revised Code. Basically, the lender—the secured party—looks for a perfected security interest. This means, in simple terms, that the lender has rights in collateral that will be valid against the borrower, his creditors and third parties. The lender must take several steps to obtain a perfected security interest. In most transactions, it is necessary to begin by obtaining a *security agreement,* the contract between the borrower and the lender in which the debtor assigns specific property to the lender as collateral for the loan and the lender agrees that he does not own the property and that the collateral is taken only to secure repayment of the loan. The lender's security interest *attaches* to the collateral only when three conditions, specified in §9-203 of the Uniform Commercial Code, are met:

(1) The creditor must give value.

(2) The debtor must have rights in the collateral.

(3) Both parties must agree that the creditor is to have a security interest in the collateral. Section 9-203, in part, provides that a security interest is not enforceable against the debtor or third parties unless the collateral is in the possession of the secured party or the debtor has signed a security agreement.

Once these prerequisities have been complied with, the lender will have obtained his security interest in, or lien against, the borrower's collateral, unless explicit agreement postpones the time the interest attaches. The lender also must perfect his position against the borrower's other creditors and third parties. To perfect a security interest, the lender normally files a financing statement with the Secretary of State, Probate Officer or another office of appropriate jurisdiction, or by maintaining possession of the collateral. The U.C.C.'s general rule of priority is of utmost importance, since it provides, with certain exceptions mentioned in §9-312, that the creditor with the earliest perfected security interest has priority over the other creditors. A lender should always ascertain the existence of prior perfected security interests, and, if there are none, he should promptly perfect his security interest. A basic working knowledge of the Code is essential in the field of security lending. However, many difficult questions are best left to the legal profession. When a lender is unsure of his position, it is always advisable to consult an attorney.

The fourth and final step is to review the overall credit on a regular basis. This step is extremely important and can prevent many problems by detecting adverse trends early enough so that remedial action can be taken. Every banker has an obligation to be as knowledgeable as possible about his customer's business and to give a borrower the benefit of his advice. Often, a little counseling at an early stage is all that is needed. This is certainly a better solution than liquidation. The review process will serve its purpose if it is regular, thorough and objective and if the results of the review are considered and followed up by the lending officer. Some of the questions which need to be asked are:

(1) Has there been any significant change in management?

(2) Are audited financial statements received on a regular and timely basis?

(3) Have the statements been carefully analyzed and compared internally with industry averages? Has consideration been given to any adverse trends, in either the balance sheet or operating statements?

(4) What has been the company's trend in bank depository balances?

(5) How are trade obligations being handled?

(6) Has the plant site been visited and an inspection of collateral made?

(7) Is the borrower adhering to the repayment schedule?

(8) Is the interest rate fair and adquate?

(9) What are current economic, industrial and competitive situations?

(10) Do margins need revision?

INVENTORY LOANS

Section 9-109(4) of the Uniform Commercial Code defines goods as inventory

> if they are held by a person who holds them for sale or lease or to be furnished under contracts of service or if he has so furnished them, or if they are raw materials, work in process or material used or consumed in a business. Inventory of a person is not to be classified as his equipment.

This definition makes it obvious that we are talking about a broad subject, ranging from the financing of inventories of manufacturers to wholesaling and retailing inventories, as well as the infinite variety of goods which could constitute inventory.

Inventory financing is a difficult and troublesome area for lenders. Experience, a special staff and a great deal of expertise are necessary before one tackles the various applications of inventory financing. Every lender should be made aware of the risk involved. "Risk," Stephen C. Diamond has said, "is purely a factor of the competence of the lender."

Why is inventory lending so difficult? No lender can be familiar with all the various types of inventory that can be financed, and, as a trading asset, inventory can change from raw materials to finished products to receivables to cash. In addition, most inventory loans result in term loans even if initially evidenced by short-term or demand notes. If it is a term loan, it is subjected to the additional uncertainties which time always creates. Banks have engaged in short-term seasonal financing for many years with satisfactory experience. Repayment of a seasonal loan comes from cash generated by the reduction of inventory from peak levels.

Difficulties with inventory financing have arisen primarily when loans against inventory have been made to growth companies or to companies with inadequate capital or working capital or made in conjunction with an accounts-receivable loan. In addition, inventory is often taken as additional collateral to shore up a deteriorated credit situation. Usually—except in the case of an inventory loan for which repayment comes from the reduction of an asset—the lender looks to the profits and depreciation of the business for repayment. In most inventory financing situations, it is unrealistic to place much confidence in the two other major sources of repayment: the injection of new capital and the transferral of the debt to another lender. This is a basic point that every lender recognizes but at some time has overlooked. Repayment plans should be based on accurate cash-flow projections and should take into consideration the relationship that must exist between sales, cost of sales and inventory in a going concern.

Margin Determination

One important consideration that every lender must face when dealing with inventory loans is the establishment of an adequate margin. Determining the value of inventory and the proper margin for an inventory loan requires determining the quantity of inventory on hand and its composition, present and future marketability and market price, and probable liquidation expense.

Let us use as an example a small food processor (see table). The company is relatively new and undercapitalized and has a shortage of working capital, but the prospects for this company seem to be exceptionally bright. We have first considered the bank's lending policy and all the basic credit fundamentals and believe that the loan will be sound if properly secured.

For this company a loan of $95,000 could be justified. This would be an advance of roughly 67% of the borrower's cost of $142,750 or 84% of estimated value. A review of the major factors considered in arriving at these figures is necessary:

(1) *Quantity*—The quantities of raw materials, work-in-process and finished product are determined by a physical inventory conducted by the lender. It is always advisable for the lender to perform the inventory rather than relying on the borrower.

(2) *Composition, mix and quality*—The physical inventory revealed that the major items of inventory were raw materials and finished products. Lump crabmeat and mixed crabmeat made up the bulk of raw materials. Work-in-process in this particular example is a minor item. As a general rule, raw materials and finished products have better marketability and liquidating values than work-in-process. No value is assigned to the smaller items of raw materials or work-in-process, since it is usually desirable to base an inventory loan only on the major items of inventory.

(3) *Present Marketability*—Raw crabmeat is readily marketable through wholesale channels and its price can be established through brokers and various publications. Since it can be sold on a wholesale market, liquidation can be accomplished rapidly. To arrive at a liquidation value, the product is compared with competitive products in terms of price and quality. Food brokers and retailers are consulted and their opinions considered in arriving at the estimated liquidation price. The finished product was assigned a value of 50% of the current selling price. Consideration was given to the fact that selling price represents cost and profit in a going concern, and when a liquidation occurs, the borrower is usually not covering cost. It is estimated that 45 days worth of sales are on hand and that liquidation can be accomplished in 90 days. The

ITEM	QUANTITY	UNIT COST OR PRICE	BORROWER'S COST	ESTIMATED VALUE	LIQUIDATION EXPENSES	ESTIMATED VALUE LESS LIQUIDATION EXPENSE
Raw Materials						
(1) Lump Crabmeat	10,000 lbs.	Retail — $4.25 lb. Wholesale — 3.25 lb. Cost — 3.20 lb.	$ 32,000	$ 32,500	$ 1,500 (Brokerage Fee)	$31,000
(2) Mixed Crabmeat	10,000 lbs.	Retail — $3.80 lb. Wholesale — 3.00 lb. Cost — 2.95 lb.	29,500	30,000	1,500 (Brokerage Fee)	28,500
(3) Celery, Onions, Bell Peppers, etc.	50 cases	$100 per case	5,000	—0—	—0—	—0—
(4) Spices	10 cases	$ 75 per case	750	—0—	—0—	—0—
(5) Cartons	20 cases	$125 per case	2,500	—0—	—0—	—0—
Work-In-Process						
(1) A Mixture of the Above	Miscellaneous	$3,000 (Cost)	3,000	—0—	—0—	—0—
Finished Product	10,000 Cases	$100 per case (Selling Price) $70 per case (Borrower's Cost) $50 per case (Estimated Liquidating Price)	70,000	50,000	5,000 (Brokerage Fee) 300 (Insurance) 500 (Storage)	44,200
					8,000 (Contingency for Price Fluctuation)	(8,000)
					700 (Attorney Fees)	(700)
TOTALS:			$142,750	$112,500	$17,500	$95,000

packing cartons are not assigned a value, since they are for a special application and probably cannot be sold.

(4) *Seasonal Characteristics*—Raw crabmeat is purchased on a seasonal basis but is sold frozen throughout the year. Its sale should present no problems. The finished product has slight seasonal characteristics but not enough to delay a sale within 90 days. Caution was exercised to determine that no held-over seasonal inventory was on hand.

(5) *Price stability*—Reliable information indicates that the wholesale price of raw crabmeat fluctuates within a range of 80 cents per pound. An allowance of 40 cents per pound has been made for price fluctuation.

(6) *Perishability and obsolescence*—All of the major inventory items are perishable. The premises are well suited for storage and the inventory is well insured with the lender named as loss payee. The inventory will not be subject to physical deterioration unless stored for one year or more.

(7) *Liquidation costs*—Selling, storage and insurance costs and attorney fees have been provided for. The estimated liquidating cost of raw crabmeat is very low, since it can be sold on an established market but the finished product cannot, since there would be additional selling expense.

Even though this example is an oversimplification, it nevertheless demonstrates that, with a little analysis, the lender can determine, with a reasonable degree of accuracy, the value of many types of inventories. If he is satisfied that he has adequately determined the value of the inventory and the proper margin, the next question is how to properly control the inventory.

Inventory-Control Systems

Systems of control in banking today range from a blanket assignment of the inventory to financing under a warehouse receipt. Any banker who has handled an inventory loan by simply relying on a blanket assignment of inventory has probably found himself in the same position as the writer: going out to the premises of a failing borrower with hopes of collecting a loan through the sale of his inventory, finding no inventory there, and subsequently writing off the loan. Perhaps the only instances in which a blanket assignment of inventory and proceeds is appropriate is when it is taken in connection with an accounts-receivable loan—which otherwise stands on its own—or when it is taken as additional collateral for an already weak loan. One step removed from the blanket assignment is an inventory loan in which the lender relies on his borrower to furnish a periodic report of inventory on hand. The lender then makes advances based on a given percentage of the borrower's reported inventory. This method, although not recommended, can work satisfactorily, if the borrower remains honest and his accounting procedures are adequate. Good financial statements and an audit at least yearly add some support to this method of handling inventory loans. But the lender must rely on his borrower for the inventory reports, which usually do not contain sufficient details for an accurate monitoring of inventory composition or of quality and mix, and the true character of a borrower is not really tested until he is faced with adverse circumstances.

If an inventory loan is properly supervised, much of the risk can be eliminated. Let us look at the usual steps in properly supervising an inventory loan, first one without warehousing and then one with warehousing. Many inventory loans, without the assistance of warehousing, require a good deal of experience and a specialized staff. Of the more than 14,000 commercial banks in the United States, only the largest 150 or 200 could justify the expense of maintaining a separate department and staff for handling this type of loan. This is not to say that smaller banks cannot successfully master this type of inventory financing, but it requires diligence, some experience and a lot of extra work to do a proper job. The first step is a complete and systematic review of the borrower's accounting system and procedures. If any deficiencies are found, the borrower is required to correct them before a reporting system can be set up. The borrower then submits regular reports to the lender based on the agreed upon system. A thorough initial physical inventory is conducted by the lender, and any additional corrections of the borrower's books are made. After this has been done, the next task is a periodic physical audit by the lender. Normally the lender will audit at least every 60 days. These audits should establish any weakness in the reporting system, determine the quantity, quality, mix and composition of the inventory, detect fraud and, in general, allow the lender to be fully informed of the overall status of the collateral. A good working relationship between the borrower and the lender is always beneficial to both parties, especially in inventory financing. The best way to accomplish this is by written agreement. Therefore, it is desirable to have a loan agreement that spells out in detail the rights and duties of both parties.

Some of the most important items that should be covered in an inventory loan agreement are:

(1) defining the inventory available for loan purposes, with consideration for the lender's desire to limit advances on certain types of inventory, such as work-in-process, slow moving items, small items, or any particular item;

(2) establishing the percentage of advance or margin on eligible inventory;

(3) setting overall loan limits;

(4) establishing an interest rate;

(5) requiring prior approval for advances on certain types of inventory;

(6) establishing a repayment agreement or the term of the line of credit;

(7) establishing a detailed procedure to be followed under the loan from beginning to end.

If a bank does not have the staff, expertise or time to properly evaluate and control inventory financing, there are various alternatives. One method of solving the problem is to ask for assistance from a correspondent bank or one of its subsidiaries specializing in this type of lending. The correspondent can set up the collateral-control system on a participation basis. There are a number of fine commercial finance companies specializing in secured lending that are quite willing to work with lenders in a participation arrangement. Participants normally charge 4% to 6% above prime on their portion of the credit. One drawback with this arrangement, in the case of smaller borrowers, is that a participant's preference for a loan in excess of $150,000 often precludes its creation.

A second alternative is to use a collateral-control service. A number of old-line warehouse companies and other companies are now providing collateral-control services. Unlike the participating companies, these companies do not enter into the loan but rather guarantee to the lender the validity of the accounts receivable and the availability of physical inventory. The fees charged for this type of service vary widely and depend on the value of the guaranteed or controlled collateral and other considerations. Fees ranging from 1% to 3% are not uncommon. Space does not permit a full discussion of the various services provided by these companies, but they can be utilized with satisfactory results. The main advantage to the lender of a participation arrangement or a collateral-control service is that he gets the benefit of the wide experience possessed by these companies. In addition, they provide excellent reporting systems, which keep the lender informed of the status of his collateral, and they assume all responsibility for setting up the systems and procedures to properly control the inventory. In some loan situations the lender can reduce his exposure considerably by obtaining the guarantee of an appropriate government agency, such as the Small Business Administration or the Farmers Home Administration. Doing this is particularly desirable when the lender questions his ability to ascertain the value of his collateral, to control the inventory or to appreciate the unusual risk involved in the credit. Government guaranties are a subject in themselves and are thoroughly covered in a number of publications.

When a warehouseman is involved in the control of inventory, there is the important new element of third-party control. In warehouse-receipt financing, the borrower's inventory is placed under the control of a warehouseman, who gives the lender warehouse receipts—the documents of title covering those goods being stored. By using this method, the lender can control the movement of the inventory from the warehouse and therefore can know exactly the amount of inventory that secures his loan. Warehouse-receipt financing is particularly applicable to slow-moving goods or bulk quantities of one item, and it can be adapted more easily to loans of smaller amounts than some of the other methods of financing inventory.

Article 7 of the U.C.C. covers warehouse receipts, bills of lading and other documents of title. The Code defines a warehouseman as "a person engaged in the business of storing goods for hire," and it states that any warehouseman may issue a warehouse receipt. Section 7-202 outlines the essential and optional terms of a warehouse receipt, and it should be read and compared against any receipt before lending against them. The essential items are:

(1) the location of the warehouse;
(2) the date the receipt was issued;
(3) consecutive numbering of receipts;
(4) a statement of whether the goods are to be delivered to the bearer, to a specified person, or to the order of a specified person;
(5) storage charges, unless goods are stored in a field warehouse;
(6) a description of the goods or packages;
(7) the signature of the warehouseman or his authorized agent;
(8) a statement of whether the warehouseman solely or jointly owns any of the goods for which a receipt has been issued;
(9) a statement by the warehouseman of any lien or security interest claimed by him.

The warehouse receipt may contain other terms if they are not contrary to the provisions of the Code.

The terminology used to describe different types of warehouses is sometimes confusing and loosely used, so some brief definitions are necessary:

(1) *Terminal Warehouse*—a warehouse separate and distinct from the firm or firms owning the goods stored in the warehouse and operated by a public warehouseman.

(2) *Field Warehouse*—a warehouse on or near the premises of the firm depositing goods in the warehouse.

(3) *Bonded Warehouse*—represents a warehouse that requires a bond to be filed with an agency of the federal government against nonpayment of customs or taxes.

(4) *Licensed Warehouse*—refers to licensing, either by federal or state governments.

(5) *Public Warehouse*—warehouseman has no ownership interest in the goods stored.
(6) *Private Warehouse*—warehouse operated or controlled by a firm owning a part of the goods stored.

The lender should exercise caution if he is not familiar with a warehouseman. In many instances a warehouseman will put the terms bonded, licensed, and so forth in his receipt even though the representations are contrary to fact.

Regardless of the terminology or the type of warehouse, the important elements in a warehouse-receipt loan are third-party control by a public warehouseman, his reputation, fnancial position and character. The warehouseman should be investigated as thoroughly as one would investigate his own borrower, since the collateral is subject to the warehouseman's control and disposition. There are many reliable, well established and well known companies with which lenders can deal confidently. A lender who does not know his warehouseman not only should find out about the warehouseman's general reputation and financial condition but also should find answers to these questions:

(1) Does his receipt conform to the Code requirement?
(2) Does he maintain adequate insurance and fidelity bonding? The insurance coverage of many warehouses omits certain hazards and perils. If this is the case, the borrower's insurance policy should be checked to make sure that his coverage is adequate and that the lender is named as the loss payee.
(3) Is the warehouse suited for the borrowers's inventory?

Bankers in some instances might want to take advantage of 12 U.S.C.A. §84(6), which permits certain exceptions to legal lending limits on obligations secured by shipping documents, warehouse receipts and other documents of title covering certain commodities.

Perfection of a Security Interest

Perfecting a security interest in inventory within the framework of the Code is relatively simple. First, before entering into the financing arrangement, search the appropriate records to determine whether one or more financing statements covering the anticipated collateral are already on file. If so, these items should be cancelled or cleared up to the lender's satisfaction. Then obtain a security agreement, file an appropriate financing statement, and make another check to be sure that no intervening liens have been entered into the records. Once these steps have been completed, the funds may be advanced.

The appropriate location for filing a financing statement on inventory is sometimes a confusing issue for lenders. Sections 9-102, 9-103, 9-104 and particularly 9-401 of the Code set forth the various rules and considerations. The proper place for filing a financing statement on inventory is usually in the state or states where the inventory is physically located. One noteworthy exception occurs when inventory is mobile and is leased by the debtor to others. When this is the case, a financing statement should be filed in the state in which the debtor's chief place of business is located. Mobile goods are generally defined as those used in more than one jurisdiction—such as automotive equipment, rolling stock, and road-building equipment. The lender should make a multiple filing or get legal advice if he has any doubts in a given situation.

The wording and content of a bank's notes, security agreements and financing statements are best left to the bank's counsel. The lender should review these forms periodically to determine their adequacy in light of changing circumstances. He should exercise particular care to ensure that the financing statement covers the debtor's entire inventory—existing or after-acquired—if that is the intent of the loan. Any time inventory is the subject matter of a financing statement, the proceeds of that inventory also should be covered.

Loans to farmers deserve special attention, because it is doubtful whether a farmer can have inventory. Section 9-109(3) states: "If goods are farm products they are neither equipment nor inventory." Goods are farm products, the section states, "if they are crops or livestock or supplies used or produced in farming operations or if they are products of crops or livestock in their unmanufactured states, and if they are in possession of a debtor engaged in raising, fattening, grazing or other farm operations." Loans secured by farm products require different treatment, and the applicable provisions of the Code should be adhered to when a loan is secured by farm products.

It should also be remembered that a purchase-money security interest in a debtor's inventory can take priority over an after-acquired-property clause. Purchasers of chattel paper or conditional sales contracts generated by the sale of the debtor's inventory can also obtain a prior position with respect to the proceeds of inventory.

If an inventory loan is to be handled under a warehouse receipt arrangement, it is well to bear in mind U.C.C. §7-503, which states in part, "A document of title confers no right in goods against a person who, before the issuance of the document, had a legal or perfected security interest in them." Whenever one creditor has a security interest in inventory and another creditor is lending against warehouse receipts, some conflicting points of law can be involved. This, from both a practical and a legal standpoint, is not a desirable situation. If the lender encounters it, he should seek legal advice. In addition, a holder of a negotiable document of title that has been duly negotiated can take priority over an earlier security interest that has been temporarily perfected or perfected by filing a financing statement.

Perfecting a security interest in a *negotiable* document can be accomplished in three ways, according to §9-304:

(1) by filing a financing statement;
(2) by taking possession of the document, or
(3) by temporarily perfecting without filing or taking possession for 21 days from the time the security interest attaches, if it is created "for new value given under a written security agreement."

A security interest in goods in the possession of a warehouseman who has issued a *non-negotiable* document of title may be perfected in three ways, according to §9-304(3):

(1) by issuance of the document in the name of the secured party (the lender);
(2) by taking possession of an assigned non-negotiable document issued in someone else's name and notifying the warehouseman of the secured party's interest, or
(3) by filing a financing statement on the goods themselves.

In light of those provisions of the Code and others, the safest course of action is to file financing statements and maintain possession of the warehouse receipts. The lender should search the appropriate records to ascertain whether another party has perfected a security interest in the goods covered by the warehouse receipts. He also should determine whether a borrower has paid storage charges on warehoused goods, since §7-209 gives the warehouseman a prior lien against the merchandise for storage costs.

The last but most important function that a banker must perform is a critical review of the loan on a regular basis. A thorough review of the borrower's annual audit, the ratio of cost of sales to inventory and figures relating to inventory can give some good clues regarding the overall condition of the loan.

Loans Secured by Accounts Receivable

Section 9-106 of the Code defines "accounts" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or a chattel paper, documents, instruments and money." "General intangibles"—rights such as good will, literary rights, rights to performance, trademarks and patents—are normally included in receivables financing.

Accounts-receivable lending is especially applicable to new and growing businesses in which working capital or capital is relatively modest or when other factors dictate a secured loan. Receivables financing can be a beneficial medium for both the borrower and lender. It can provide the borrower with the cash needed to take discounts and can help a growing borrower become a mature, strong, desirable customer. Receivables financing is also appropriate for a borrower with seasonal characteristics, such as a retail merchant during the Christmas period. Of course, accounts-receivable lending can go hand in hand with inventory financing, but a lender, normally looks to the accounts receivable first and to the inventory second. As a general rule, accounts-receivable financing presents less risk to the lender than an inventory loan. One reason is that an account is one step closer to cash than inventory. Second, most lenders can determine the value of accounts by analyzing the credit standing of the account debtor, a process they are thoroughly familiar with, instead of trying to determine the value of a given inventory. In addition, control over the collateral is somewhat simpler. Finally, the overall credit-worthiness of a receivables borrower is usually superior to that of a borrower seeking inventory financing.

The accounts receivable, like inventory, must bear a reasonable relationship to sales or cost of sales in a going concern. Unless repayment will come from cash generated by the reduction of an asset, most receivable loans will be term loans, even though they will be handled on a short-term basis. Accordingly, receivable lines of credit or loans should be structured only after proper cash-flow projections have been completed.

Basically, the two elements which establish the value of accounts are their validity and collectability. After the lender has received from the prospective borrower a complete listing and aging of all accounts receivable as of a given date, a judgment on the validity and collectability of the accounts must be made. The first thing to look at in this connection is the industry within which the prospective borrower is operating. Some industries have a history of high credit losses and slow paying records, and some loans might be excluded on this basis. Other factors which aid in determining an account's validity and collectability are:

(1) *Partial Shipments*—Do any of the accounts represent monies owed your borrower for a shipment under a larger order? If they do and liquidation occurs, the collectability of those accounts is doubtful.

(2) *Validity of Order*—Has the merchandise covered by the accounts receivable actually been ordered by your borrower's customers?

(3) *Sale and Delivery*—Do all accounts represent unqualified sales, and has delivery been made?

(4) *Product Quality*—Does your customer sell a good-quality product, and what is the record of rejection and allowances?

(5) *Reciprocity*—Does a borrower purchase from any of his account debtors? If so, the possibility of offsets exists.

(6) *Advance Deposits*—Does the borrower hold deposits from his customer for merchandise on future delivery? If so, these deposits might be offset against future receivables.

(7) *Account Turnover and Aging*—Has the turnover and aging of the accounts been analyzed? How does the turnover of the receivables compare with industry figures, prior years and your borrower's selling terms?

(8) *Account Concentration*—What is the spread of the accounts? Do one or two accounts represent a disproportionate dollar volume of the total accounts receivable?

(9) *Loss Experience*—What is your borrower's loss experience?

(10) *Collectability*—Have we satisfied outselves about the collectability of the significant dollar value of the total accounts receivable?

(11) *Audit*—Have we verified and confirmed the validity of the outstanding accounts directly with the account debtors?

After these and other factors have been considered, it should be possible for the lender to arrive at a dollar figure which he could collect from liquidating the receivables. If, for example, a borrower has $100,000 in valid outstanding accounts, and the lender estimated that collections in a liquidation would amount to $95,000, he would automatically set a margin of at least 5% for uncollectable accounts. Normally, the lender would set the margin at a higher percentage, because the composition of the accounts will change and a factor of 5% for doubtful accounts therefore might not be adequate. For purposes of discussion, let us assume that the lender decides on a 15% margin for doubtful accounts. In addition to this, he estimates that attorney fees and collection expenses will be $15,000. So a 30% margin or a $70,000 loan would be appropriate.

The particular method of handling a receivables loan depends to a large extent upon the circumstances involved in each particular case. Some of the more prevalent types of arrangements are blanket assignment, non-notification, direct notification and factoring. Under a blanket assignment, the lender obtains a perfected security interest in the debtor's existing accounts, but generally has little, if any, control over them. When a loan is structured this way, the lender admits that the loan will not stand as an unsecured transaction, but his thinking that he has a secured loan is a delusion. In most cases, just the opposite is true. There is no justification for handling a loan on this basis.

Non-notification is the term used to indicate that the borrower's account debtors are not notified that monies owed to the borrower have been assigned to the lender. There are many variations of non-notification financing. They differ principally in the extent to which a lender tries to continuously analyze the factors influencing validity and collectability. The principal safeguards utilized by lenders are:

(1) audit of the borrower's records;
(2) independent verification of outstanding accounts; and
(3) control over proceeds of accounts.

Under a strict arrangement, the lender, continuously audits the books of the borrower and verifies the existence of receivables directly with the account debtors. He places strict controls over record-keeping procedures, so that he is reasonably sure that any new accounts are valid. Collections are usually segregated and controlled, so that the lender can take a beginning balance of accounts receivables, add new accounts, deduct payments and thus determine the accounts outstanding. It is impossible to recommend any set procedure concerning the proper method of handling a non-notification loan without first being appraised of all the circumstances surrounding the credit. As a minimum, if reliance is to be placed on the values of the collateral, the lender should receive periodically a complete listing and aging of outstanding receivables and should make some independent verification with account debtors. These efforts, coupled with good financial information and a regular review process, should give credence to collateral values and the overall status of a given credit.

In some cases, setting up an accounts-receivable loan on a direct notification basis is quite simple, since the account debtor acknowledges the existence of the account before the disbursement of the loan proceeds and agrees to remit payments directly to the lender. Notification can be accomplished in a number of ways. One way is to have a separate note with a coinciding maturity date tied to each invoice. The advantage of this arrangement is that the account is verified before funds are advanced, which allows the lender to control the proceeds and immediately know when an account becomes slow or uncollectable. Of course, the disadvantage is that the system is cumbersome if the lender is dealing with a borrower who has many accounts. Direct notification can be simplified somewhat by eliminating the feature of having one note for each invoice and by setting up the accounts receivable line based on the total of the outstanding invoices. The major drawback with this type of financing is borrower resistance to the direct-notification aspect.

Regardless of the method used to control and evaluate the collateral, the overall line or loan should be covered by a written loan agreement detailing exactly how the line or loan will be handled.

The procedure to perfect a security interest in accounts receivable is similar to that used in an inventory loan. It entails a search of the records to determine if there are any existing prior liens on the accounts receivable. It is extremely important to make certain that no other lender is financing the borrower's inventory, because another lender could have a prior perfected security interest in the accounts receivable as a result of his claiming the proceeds from a sale of the inventory. After the search has been completed, a security agreement should be obtained and the appropriate financing statement filed. Before funds are advanced, another check of the records should be made to be certain that no intervening liens have been filed. Financing statements are normally written or worded in general terms to cover not only "the accounts, contract rights and general intangibles now existing or hereafter arising," but also the rights of the debtor in the goods and the proceeds of the described collateral. Generally, adherence to these steps will protect the lender by providing him with a perfected security interest in the collateral of the debtor.

The appropiate place for filing a financing statement for accounts receivable, contract rights and general intangibles is governed by §§9-103 and 9-401 of the Code. Accounts or contract rights must be filed where the assignor of accounts or contract rights keeps the records concerning them; general intangibles must be filed in the state in which the assignor's "chief place of business" is located. Official Comment 3 to §9-103 clarifies "chief place of business" as meaning "the place from which in fact the debtor manages the main part of his business" and not the place of incorporation. If there is any doubt concerning where the assignor of accounts or contract rights maintains his records, multiple filing or legal advice is recommended. The same procedure should be followed if there is any doubt about the assignor's chief place of business when filing on general intangibles.

Any loan based on the assignment of receviables or contracts from the federal government must comply with the Miller Act, 40 U.S.C.A. §§270a-270d, or the Assignment of Claims Act, 31 U.S.C.A. §203 and 41 U.S.C.A. §15. The assignee should file written notice of the assignment with the government and send a copy to any surety who might be involved. The provisions of this Act are beyond the scope of this article. Perhaps the best advice is to consult with the bank's counsel on contracts or receivables of this nature, unless one is thoroughly familiar with this type of financing.

Another complex area within the realm of receivables financing is the financing of a contractor's receivables. This area is fraught with both practical and legal pitfalls too numerous to mention, and if experience has not already illustrated this point, one need only talk with someone who has engaged in this form of financing. For an in-depth discussion of receivables loans to contractors, one might be interested in several papers published by the research staff of the Robert Morris Associates, referred to in the bibliography.

LOANS SECURED BY STOCKS AND BONDS

Compared with receivables and inventory lending, loans secured by stocks and bonds are a relatively safe and clean-cut form of financing and can be handled in most cases without extensive experience or a special staff. Complacency—failure to have or adhere to lending policy or failure to comply with the basics of credit—is probably the worst enemy when lenders deal with these types of loans. Before making a loan secured by stocks and/or bonds, the lender should bear in mind this axiom: "A loan which has to be repaid by the liquidation of collateral is not a good loan."

The factors influencing the values of stocks and bonds can be divided into quantitative factors and qualitative ones. The quantitative factors include operating statistics, balance sheet position, capitalization, trends within the company, earnings and dividends. Some of the more important qualitative factors are the nature of the business, its relative position within an industry, its physical, geographical and operating characteristics, the quality of management, its stability and the trend of earnings. Considering these factors, the market forms its opinion of the security and expresses that opinion in terms of price, price stability, marketability and yield. Of course, there are a number of sources of information readily available to the lender for assistance in evaluating a particular security. In many cases a thorough analysis of an issue has already been done by independent companies such as Standard & Poor's or Moody's, by brokerage houses or by the larger banks.

As a general rule, stocks and bonds traded on the major exchanges and government securities have a high degree of marketability. Many over-the-counter issues also have a broad and stable market, but some caution should be exercised in lending against over-the-counter and locally traded issues. The prices quoted for some of them may be artifically high, and the sale of a sizable block of stock could drastically reduce the market price. Some diversification of collateral is usually desirable, and a loan without diversified collateral deserves closer scrutiny. A lender should exercise special care before making a loan secured by stocks or bonds in a closely held corporation. These securities may or may not have value, and, in most cases, they cannot be readily converted to cash. Banks are prohibited from making loans secured by their own stock. Lenders may encounter problems lending against securities which are restricted or those which have not been registered under the federal Securities Act. If one contemplates a transaction of this type, he should consult his lawyer. The circumstances surrounding each loan dictate the proper margin; generalizations can often be dangerous, and none will be made.

Consideration of all these factors should enable the lender to establish the value of his collateral and, at the same time, to get a pretty good idea of the necessary margin. Lending policy should be established within each lender's institution and, among other things, should address the question of desirable and undesirable types of collateral and establish margin requirements for each form of collateral.

Control and evaluation of securities is a relatively easy task. The lender will in most cases have possession of the securities themselves and therefore will have control over them. The process of evaluation should entail regular and frequent review of the value of the collateral and of the adequacy of the margins. Control over collateral should entail systems to detect any stock splits or stock dividends, which could erode the bank's margin. Establishing sound auditing procedures is essential to ensure that dual control over substitutions and releases is maintained.

Section 9-304(1) of the Code states that a "security interest in money or instruments (other than instruments which constitutes part of chattel paper) can be perfected only by the secured party's taking possession." This section goes on to mention several temporary exceptions, but any method of perfection other than possession can present some serious problems. Maintaining possession of instruments is highly desirable; before exceptions are made, the lender should carefully review the applicable provisions of the Code and seek legal advice if necessary. Some of the common items of documentation used in making loans against stocks and bonds are these:

(1) *Note*—The form and content of a secured note should be reviewed by bank's counsel.

(2) *Possession of Stock or Bond*—This is necessary to perfect security interest.

(3) *Stock or Bond Power*—This form assigns the owners interest and gives the lender the power of attorney to sell the collateral.

(4) *Hypothecation Agreement*—This form is necessary when the security is owned by a party other than the borrower.

(5) *Special Resolutions*—When corporations borrow or pledge assets, special resolutions authorizing them are called for.

(6) *Form U-1*—The Federal Reserve requires a statement of purpose on loans directly or indirectly secured by stock regardless of the purpose of the loan. The term stock generally includes any security which is convertible into stock or which otherwise entitles the owner to share or participate in any profits of the issuing company. If the loan is for the purpose of purchasing or carrying securities, it is also subject to the credit limitations and restrictions of Regulation U-1.

(7) *Collateral Agreement*—This is an optional agreement. It can, among other things, provide that the lender will have a lien on any assets in the lender's possession.

In summary, loans secured by stocks and bonds are highly desirable and a safe form of lending, provided that:

(1) bank policy is adhered to;

(2) credit fundamentals are followed;

(3) a careful analysis is conducted to establish collateral values and proper margins;

(4) the collateral is in the lender's possession;

(5) the value of collateral and the overall loan is revised on a regular basis.

LOANS SECURED BY CASH VALUE OF LIFE INSURANCE POLICIES

Loans secured by life insurance policies are a relatively comprehensive subject and are covered thoroughly by an excellent book, *Manual on Life Insurance Loans,* published by the American Bankers Association. In addition, the association has designed and distributes forms which will assist lenders in successfully handling loans secured by life insurance policies. These forms are (1) Form No. 16 "Life Insurance Assignment Questionnaire;" (2) Form No. 10, "Life Insurance Assignment," and (3) Form No. 12, "Life Insurance Assignment Release." Many aspects of a loan secured by life insurance policies will be covered by using these or similar forms.

There are many different types of insurance policies in existence; some of the more common ones are referred to as term, whole life, limited payment, endorsement, annuity, industrial, and group. Normally, a lender takes an assignment of a life insurance policy as protection against the borrower's death or as collateral when the policy has cash value. Loans based on policies without cash value should not be classified as secured loans. Consequently, this discussion is related principally to those loans secured by cash values of insurances policies. Some of the basic considerations related to a loan secured by life insurance are:

(1) credit fundamentals;

(2) thorough and comprehensive review of the policy, since each has different characteristics;

(3) credit standing of the insurance company;

(4) a completed questionnaire (Form No. 16) signed by the insurance company, which will verify the ownership of the policy, the terms of premium payment, premium lapse provisions, notification provisions in the event of premium non-payment, cash values and encumbrances, liens on the insurance company's records, beneficiary and many other pertinent features;

(5) a completed Assignment Form,—Signed by the owner and in some cases the beneficiary and acknowledged by the insuring company.

There are many other points that could be considered, but, a look at a few potential problem areas is probably more helpful:

(1) *Incontestablity*—Generally after two years a policy becomes incontestable in the event of suicide by the insured. Suicide before two years generally provides only for a return of premiums.

(2) *Does the beneficiary have to sign the assignment?* It is always safer to have the owner and beneficiary sign. In certain states, it may be adquate for only the owner to sign, if the beneficiary designation is revocable and rights of the beneficiary are

clearly subordinated in the policy and community property is not involved.

(3) *Assignability*—The policy must be assignable.

(4) *Settlement options*—The lender should be satisfied with settlement options or have them amended.

(5) *Community property*—In community property states, the husband and wife should both sign the assignment form, and, futhermore, the lender would be well advised to seek legal aid in some cases.

(6) *Special precautions and documentation*—This may be called for if the insured is not the owner of the policy, if the policy is owned by a corporation, or if the policy is assigned to secure the debt of someone other than the owner.

Loans Secured by Petroleum Production, Ship Mortgages and Aircraft

Loans secured by a mortgages and assignments of oil- and gas-producing properties, ship mortgages, equipment and aircraft generally fall within the realm of term lending. In a few instances, however, these forms of collateral are used in connection with short-term lending. Coverage will be limited to a few random comments.

A direct petroleum production loan may be defined as a self-liquidating loan with repayment coming from the oil and gas derived from the mortgaged properties. Geography will in part determine whether a lender is justified in entering into this field of lending, but, in general, this type of lending is highly profitable for the many banks engaged in it. Not only do the oil and gas runs usually permit a relatively quick and regular payback, varying from a few months to several years, but loans of this type command good rates and often generate excellent deposit relationships.

Perhaps the greatest drawback for most lenders in this area is the necessity of determining the value of the oil and gas reserves which consitute the lender's collateral. Lenders engaged in petroleum financing on a large scale basis will normally employ petroleum engineers or use the services of firms specializing in this field. In layman's terms, the engineer establishes the present value of the income stream to be derived from the oil or gas runs. As a rule of thumb, many lenders then advance 50% of the estimated present value. Some of the other major considerations in this type of lending are these:

(1) There is an inverse relationship between risk and the number of wells securing a loan. Lenders will usually require a minimum of two wells before lending against production.

(2) The lender must ascertain that the title to any mortgaged property is clear.

(3) There must be a connection with a pipeline or a valid purchase agreement for the production.

(4) The operators of the well should be competent and the lender thoroughly satisfied with their ability.

Loans secured by boats, ships and aircraft will be mentioned only for the purpose of pointing out their unique legal status. The Ship Mortgage Act of 1920 affords a lender much superior protection by granting the lender a perferred ship mortgage. Generally, a lender may obtain a preferred ship mortgage of vessels of the United States exceeding five tons (as a rule of thumb, 35 feet in length). If the vessel is a towboat, scow, lighter, car float, canal boat or tank vessel, a minimum displacement of 25 gross ton applies. The rights obtained under a preferred ship mortgage are far superior to those obtained by having a security interest in the vessel. A preferred ship mortgage can be primed, or defeated, only by:

(1) prior maritime liens which attach before the date of the mortgage;

(2) tort liens created when the vessel does something offensive to society such as running into another vessel;

(3) crews' wages;

(4) salvors liens, which can be created if a qualified salvor saves the vessel.

The risk associated with those four situations, which can prime a preferred ship mortgage, can be virtually eliminated by the lender. First, the lender should know his borrower and require him to sign an affidavit that there are no prior liens. Under the Ship Mortgage Act, a false statement subjects the borrower to two years in a federal prison, a $1,000 fine or both. This usually is sufficient protection against prior liens. The lender protects himself against torts by having proper protection and indemnity insurance assigned, and hull insurance protects him from salvor's liens. Crew wages seldom present a major problem, since crewmen will promptly quit if they are not paid and the lender will soon be apprised of the circumstances. By utilizing the preferred ship mortgage and proper insurance, the lender can eliminate virtually all of the legal problems that could evolve if he simply relied on a security interest. In addition, the lender can charge whatever rate he deems appropriate, regardless of state usury laws, since he will be operating under federal statute and within well defined legal areas. While there are no insurmountable difficulties in properly documenting a preferred ship mortgage, there are a number of fine points to be considered. The lender will usually benefit by allowing his counsel to prepare the documentation and by obtaining a legal opinion.

The financing of aircraft is covered by the registration provisions in §503 of the Federal Aviation Act, which is codified as 49 U.S.C.A. §1403. The Federal Aviation Act establishes a system for recording conveyances affecting the title to or an interest in civil aircraft of the United States and provides that no subsequent conveyance of title or an interest will, until it is recorded, be valid against any person other than the one making the conveyance or his heirs or devisees or any person having actual notice. In essence, failure to follow the provisions of the Act can place the lender in a precarious position with respect to third parties. The requirements for recording liens and conveyances are contained in 14 C.F.R. pt. 49, "Recording of Aircraft Titles and Security Documents." In addition to complying with this Act, a lender may want to perfect a security interest under the Uniform Commercial Code.

CONCLUSION

Thus far, a positive approach to secured lending has been emphasized. However, every lender, despite his diligence, will be faced with the problems of failing borrowers, liquidation of collateral, or, worse yet, a borrower's bankruptcy. These unfortunate situations can be caused by many factors, but, usually, they will fall within three broad areas: adversity, mismanagement or fraud. If the lender is able to exactly pinpoint the problem, he will be in a much better position to determine the course of action to take. If fraud has been committed, the lender obviously can no longer consider working with the borrower. Under the other circumstances, the lender will often benefit by continuing to work with a borrower.

Probably the most difficult decision facing a lender is determining when it is necessary to call a loan and begin the process of liquidating collatral. Experience and sound judgment are two critical intangible qualities the lender must possess or rely upon when making this decision. Therefore, it is highly desirable to utilize the collective experience and judgment of a senior loan committee or similar group when faced with this decision. Once a decision has been made, immediate action and follow-up should ensue. Failures or delay in following up will often prove to be costly and will result in a loss of control over the credit. Before a decision to liquidate a borrower is made, a prudent lender should always seek legal advice. Legal advice at an early stage is an invaluable aid in weighing the alternate course of action and preventing or rectifying costly errors in documentation. Consideration of the following questions will often assist the lender:

(1) What are the facts?
(2) What is the problem?
(3) What is the lender's legal position?
(4) What are the various alternatives for a solution to the problem?
(5) What is the best solution?
(6) Has proper emphasis been placed on immediate follow-up?
(7) Has the lending institution taken full advantage of the

experience and judgment possessed by its personnel in considering the above questions?

Secured lending offers opportunity, challenge, risk and reward to the lender. Loans secured by some forms of collateral are inherently more difficult to manage and involve a higher degree of risk than others. The extent to which a particular institution engages in the various types of secured lending should be established by lending policy. Shortcuts can expose the lender to inordinate risk. On the other hand, a careful and deliberate approach to each loan will minimize risk and maximize the rewards for the lending institution.

Good luck!

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