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DISPATCHES FROM THE TRENCHES

A Little Something about Collateral Categories under Article 9

The last edition of Dispatches from the Trenches generally discussed what kind of property and transactions are, and are not, subject to Article 9 of the Uniform Commercial Code.

This edition focuses in a little more detail on the various, highly defined collateral categories created by Article 9. Please note that there are more intricacies to the definitions outlined below; special provisions for healthcare insurance receivables, credit card processing companies and farming operations; and other matters which are beyond the scope of this column.

A. Goods.

“Goods” are technically defined to include “all things that are movable when a security interest attaches.”¹ Of course, the definition of Goods is several lines longer than what is quoted above and describes additional items such as standing timber that is to be cut and removed under a conveyance or contract for sale; the unborn young of animals; crops grown, growing, or to be grown, even if the crops are produced on trees, vines, or bushes; and manufactured homes.

There are also several sub-categories of Goods that are defined in Article 9. Two of the most often discussed subcategories categories of Goods are inventory and equipment.

“Inventory” means Goods, other than farm products, which are leased by a person as lessor; are held by a person for sale or lease or to be furnished under a contract of service; are furnished by a person under a contract of service; or consist of raw materials, work in process, or materials used or consumed in a business. Dealers of Goods who pledge them as collateral would be granting a security interest in “Inventory.”² Similarly, if Goods are rented to third parties by a borrower, those Goods constitute “Inventory” under Article 9. There are a variety of intricacies with respect to inventory lending that have been addressed from time to time in Dispatches from the Trenches and anyone involved in such transactions is advised to take special precautions.

“Equipment” is one of the shorter definitions in Article 9. It is a catchall category for Goods and is defined to be “Goods *other than* inventory, farm products, or consumer

¹ See U.C.C. §9-102(a)(44).

² See U.C.C. §9-102(a)(48)

goods.³ Consumer Goods are Goods that are used or bought for use primarily for personal, family, or household purposes.⁴ Farm Products are certain Goods arising from farming operations.⁵

There are a couple other things worth noting about Goods. First, the term "Goods" expressly includes a computer program embedded in Goods and any supporting information provided in connection with a transaction relating to the program if (1) the program is associated with the Goods in such a manner that it customarily is considered part of the Goods, or (2) by becoming the owner of the Goods, a person acquires a right to use the program in connection with the Goods. The term does not include a computer program embedded in Goods that consist solely of the medium in which the program is embedded (such as a computer program sold on a CD).⁶

Second, there are several other defined terms in Article 9 which describe Goods but which do not constitute a distinct category of collateral, such as Fixtures and Accessions. Technically, these categories of collateral could be consumer goods, equipment or inventory.

B. Rights to Payment.

Although a "Right to Payment" is not a defined term in Article 9 and not used within the text of the statute, it is a helpful way to conceptualize collateral categories defined in Article 9 as "Accounts", "Chattel Paper", "Instruments", "Investment Property", "Deposit Accounts" and "Letter of Credit Rights".

An "Account" consists of a right to payment of a monetary obligation whether or not earned by performance for (1) property that has been sold, leased, licensed, assigned or otherwise disposed of; (2) services rendered or to be rendered; (3) energy provided or to be provided and (4) several other items.⁷ The term does not include, however, rights to payment evidenced by chattel paper or an instrument, deposit accounts, investment property, letter of credit rights and a few other items.

"Chattel paper" includes writings (whether electronic or tangible) that evidence both a monetary obligation and a security interest in, or lease of, specific Goods. In other words, an equipment lease is chattel paper. A secured loan in which the specific Goods are pledged as collateral is also be chattel paper. An all asset security interest under a senior secured credit facility would not constitute chattel paper. The term also expressly excludes charters or other contracts involving the use or hire of a vessel.⁸

"Instruments" include any negotiable instrument or other writing evidencing a right to the payment of money that (1) is not a security agreement or a lease; and (2) is of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment. Classic examples of instruments include promissory notes, checks and drafts. Investment property and letters of credit are expressly excluded from the definition of an instrument.⁹

³ U.C.C. §9-102(a)(33).

⁴ U.C.C. §9-102(a)(23).

⁵ U.C.C. §9-102(a)(34).

⁶ U.C.C. §9-102(a)(44).

⁷ U.C.C. §9-102(a)(2).

⁸ U.C.C. §9-102(a)(11).

⁹ U.C.C. §9-102(a)(47).

“Investment Property” means a security, whether certificated or uncertificated; securities account; securities entitlement; commodity account; or commodity contract.¹⁰ Examples of securities include stocks, bonds and similar assets that qualify as securities under Article 8 of the UCC. If it is certificated, there is a physical certificate evidencing that interest. If it is uncertificated, it means the rights are evidenced by a notation on the books of the issuer. A securities account is an account in which a financial asset (like a security) is maintained by a clearing corporation or securities intermediary (like a broker). A securities entitlement is the rights of the investor with respect to such financial assets in a securities account. A commodity account is a commodities future contract or option. A commodity account is like a securities account but for commodities contracts.

“Deposit Accounts” include a demand, time, savings, passbook or similar account maintained with the bank. The term excludes investment property and accounts that are evidenced by an instrument.¹¹

“Letter of Credit Rights” includes a right to payment or performance under a letter of credit, whether or not the beneficiary has demanded or is at the time entitled to demand payment or performance. The term does *not* include the actual right of a beneficiary to *demand* payment or performance under a letter of credit. In many cases, lenders requiring letters of credit as additional credit support require a Standby Letter of Credit which lists the lender as the beneficiary and party entitled to draw upon, and receive the proceeds of, the Letter of Credit. It should be noted that, although some Letters of Credit are governed by Article 5 of the UCC, other law is often chosen by parties with respect to such issues such as the International Standby Practices 1998, International Chamber of Commerce Publication 590 (“ISP”) or the Uniform Customs and Practice for Documentary Credits 2007 Revision, International Chamber of Commerce Publication No. 600 (“UCP”).

C. General Intangibles.

“General Intangibles” is essentially the catch all category of collateral. If you can’t find another Article 9 category for a type of collateral, it is a general intangible.

D. A Lesson in Complexity

When analyzing a given transaction, it is important to understand that the *Debtor’s use* of the collateral greatly impacts the manner in which it is categorized.

For example, if a Secured Party lends money to a dealer of forklifts, those forklifts would be “inventory” while held for sale by the Debtor. If the dealer sold the forklift in exchange for a promise from the purchaser to pay the purchase price within a set period of time, the right to receive the payment would probably be an “account” of the Debtor. However, if the promise were represented by a promissory note, it would be an “instrument” instead of an account. If the note were coupled with a security agreement granting a security interest in the forklift (or was an equipment finance agreement or similar document), it would be a “chattel paper” instead of an account or instrument.

¹⁰ U.C.C. §9-102(a)(49).

¹¹ U.C.C. §9-102(a)(29).

This complexity is one reason why lenders that floor-plan inventory often require a security interest in accounts, instruments and chattel paper evidencing the sale of that inventory.

Another good example of complexities in classifying collateral is the membership interest (or other ownership interest) in a limited liability company or a limited partnership.

For example, it is common in the industry for lenders involved in certain project financings to take a security interest in the ownership rights that the parent has in the project company which owns and operates the project. In most cases, a membership interest in a limited liability company or a partnership interest in a limited partnership is a "general intangible" for purposes of the Article 9. However, the issuer of an LLC or partnership interest can invoke Article 8 to change those interests into "securities" for purposes of the Article 9 rules (which would change the collateral type to Investment Property).

The possibilities are endless. The key point is to have a good understanding of the various collateral categories, the nature of the debtor's business and which kinds of collateral morph into others in that context.

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