

USE OF THE "BLANKET" SECURITY INTEREST FOR TRADE CREDITORS IN OUT OF COURT WORKOUTS⁸

By Geoffrey L. Berman and Robert J. Hoder¹

Today's workout scenario has changed in recent years. The major change has been the overriding security interest in a debtor's assets given to the asset based lender, to an extent that precludes value to lower priority (i.e. unsecured) creditors. This has taken away any leverage the trade creditor has had in trying to effect some meaningful recovery from the distressed debtor. A few years ago, the concept of granting a security interest in a debtor's assets was explored in these situations and today, in many instances this has become almost a mandatory part of the debtor's efforts to reorganize out of court. This paper explores the purpose behind the junior blanket security interest, how it works and how it withstands creditor attack.

The purpose of this junior security interest is in part to keep any equity in a debtor's assets

¹ Geoffrey L. Berman is a Vice President and Senior Consultant with Development Specialists, Inc., a turnaround management and consulting firm and is based in DSI's Los Angeles office. Before joining DSI Mr. Berman was the Assistant Secretary of Credit Managers Association of California and Manager of its Adjustment Bureau, which administers out of court work outs on a regular basis. He has a JD degree from Southwestern University School of Law and his undergraduate degree, cum laude, from the University of the Pacific, Stockton, CA where he majored in Business Administration (Accounting and Finance) and wrote an Undergraduate Honors Thesis in Finance.

Robert J. Hoder is an Estates Manager for the Adjustment Bureau of Credit Managers Association of California after serving as President of the National Association of Credit Management affiliate in Detroit, MI for ten years. Bob earned a B.S. degree from the Detroit College of Business and served as a state court appointed trustee in Michigan and is certified as an expert witness in the United States bankruptcy Court, Western Region of Michigan. Geoff and Bob have over twenty plus years administering work outs.

available for unsecured creditors. But it has other beneficial aspects. Probably the most important of these is the concept of "leveling the playing field" among unsecured creditors. All too often unsecured creditors perceive an out of court work out as an invitation to be the first to the court house and either obtain an attachment lien as a pre judgment remedy² or to pursue judgment on the claim and then recordation of that judgment creating a judicial lien³. Where there is no prior perfected secured creditor or lender, this interest becomes even more important.

When a debtor grants unsecured creditors a junior lien, all general unsecured creditors now become in effect members of a class of secured creditors; no one creditor gains an advantage over others because they are protected, at least to the extent of a debtor's assets, from greater loss. As part of this process, an issue of how to document the security interest arises.

Obviously, perfection of security interest rules do not allow for a debtor to create individual security interests for each creditor, as the perfection and priority rules under the Uniform Commercial Code would give priority to the first such interest **recorded** in the series of financing statements⁴. Therefore, a debtor needs to create a single security interest in favor of a "Stakeholder", who holds the security interest for the benefit of the class of unsecured creditors.

Furthermore, because the stakeholder may not (or should not) be a creditor of the debtor, the

² As provided under California Code of Civil Procedure §491.415.

³ See California Code of Civil Procedure §1800(4).

⁴ Uniform Commercial Code §9-312(6).

stakeholder should be looking to the affected creditors for direction in enforcing the terms and provisions of the security interest granted. The simplest way to do this is by requiring the unsecured creditors to be organized and the creation of an Unofficial Committee of Unsecured Creditors, which committee has independent counsel. This enables the stakeholder to refrain from taking any independent actions on its own; the actions are those of the creditors secured by the lien. A sample Stakeholder Agreement and Security Agreement are included with this article, marked as Appendix A and B respectively.

There have been a number of attempts to attack these junior interests in state court proceedings. To date, it has been our experience that the junior lien has been upheld over the claims of the attaching creditor. These cases have not been published and as such, there is no written precedence. However, quoting a recent decision:

It appearing that substantial value was given for the security interest, the security interest granted by the Security Agreement has attached, and that **CMA holds in trust for the benefit of all creditors** a duly perfected and valid security interest with priority over [the] lien creditor.... it is hereby ordered that the Third Party Claim filed by CMA be, and hereby, is granted (emphasis added).⁵

Attaching creditors have ranged from small dollar claims to over \$1.0 million in the case of the out of court reorganization of **Everex Systems, Inc.** (claim of Samsung USA). Furthermore, the

⁵ In re Alliance Financial Capital, Inc. v. Peripheral Land, Inc., Municipal Court of the State of California, County of Alameda, Fremont-Newark-Union City Facility, Order Entered April 5, 1995.

granting of such a security interest is in keeping with the purpose of The California Uniform Fraudulent Transfer Act⁶. The Legislative Committee Comments to Act - 1986 Addition states that the statute is "to protect a debtor's estate from being depleted to the prejudice of the debtor's unsecured creditors"⁷.

Is there consideration for the granting of the security interest. The California Uniform Fraudulent Transfer Act states that "(v)alue is given for a transfer for an obligation if ... an antecedent debt is secured."⁸ Generally, the question centers on whether the value of the security interest exceeds the debt being secured. But as we described previously, if there is little or no equity in the assets of the debtor beyond the senior secured lender, there is almost no chance that the unsecured claims will be worth less than the value of collateral pledged. And while California permits a debtor to prefer one creditor over another⁹, this process prefers no unsecured creditor over any other, eliminating the argument (and the need) for one creditor (or creditors) to race to the courthouse to gain an advantage over others.

Another question frequently asked is whether the creation of a junior security interest will not cause a senior secured lender to withdraw financing from the debtor. Concern generally lies with the issue of priming the senior lien. Rather than think of this junior lien as a mechanism to

⁶ California Civil Code §3439.03 (West 1997).

⁷ Id.

⁸ Id.

encroach on a senior lienholder, the junior lien is really a means of insuring a more orderly approach to the reorganization of the debtor. New monies raised by a debtor can be placed ahead of the junior lien if the security interest is created in a manner that allows such priority to new money. Is there any chance that unsecured creditors are going to attempt to foreclose a senior lien if the class has to advance (or raise) significant additional monies over their previous advances? Not really.

What happens when the debtor fails to keep its reorganization effort out of the bankruptcy court.

The security interest is generally upheld, depending on the language used in the security agreement¹⁰. Or, the junior interest gives the unsecured creditors the benefit of the bargain negotiated. One such instance occurred in the out of court work out attempted by **Good Stuff Food Company, Inc.** When the debtor was unable to continue outside of bankruptcy court protection, the debtor filed¹¹ a voluntary petition under Chapter 11¹². The claims of the senior secured lenders were believed to be worth the substantial majority of the value of the company's assets. But there was believed to be equity in the estate for unsecured creditors. That now appears to be the case. The bankruptcy case was ultimately dismissed as the three secured creditors (including the trade's junior lien) are the only creditors who will see any recovery from

⁹ See *Wyzard v. Goller*, 23 Cal.App. 4th 1182 (1994).

¹⁰ Wherein a junior security interest might be invalidated by the terms of the security agreement itself.

¹¹ In re Good Stuff Food Company, Inc. case No. LA 92-41584 WL .

¹² 11 U.S.C. Section 1100 et seq. (commonly known as the Bankruptcy Code).

the assets of the debtor.

What happens when the debtor can not succeed inside a bankruptcy. The secured creditor can foreclose on its interest as a means of enforcing the security interest and generating the recovery for creditors, or, the committee overseeing the interest for the class can threaten the foreclosure if a debtor will not agree to some other means of liquidation¹³. The benefit of the security interest inures to unsecured creditors as a class and not to any one creditor individually.

The reality is that the benefit of the security interest to the unsecured class helps structure the work out; it gains creditor cooperation, leaving management of a debtor to focus on its problems of returning the debtor to profitability and not be lost in the morass of creditor attempts to deflect management's attentions to the real problems at hand. Professionals advising debtors should look more closely at the benefit of using a junior security interest and stakeholder agreement, as should asset based lenders when facing a distressed situation, and be less inclined to avoid the chance of success that the junior lien brings.

EXHIBIT "A"

SECURITY AGREEMENT

1. Grant of Security Interest

¹³ Reference here is to the process of a general assignment for the benefit of creditors under state law or potentially an involuntary petition in bankruptcy.

("Debtor") hereby grants to "Stakeholder" as trustee for all creditors of the Debtor ("Secured Party"), a security interest, pursuant to the California Uniform Commercial Code, in all of the Debtor's assets ("Collateral") including its Accounts, General Intangibles, Inventory, Equipment, and Other Assets described herein and the Proceeds and Products thereof:

2. Definitions

A. The term "Accounts" means any right of Debtor to payment for goods sold or leased, or to be sold or to be leased, or for services rendered or to be rendered no matter how evidenced (including, without limitation, accounts receivable, contract rights, purchase orders and other forms of obligations) whether or not earned by performance, whether now existing or hereafter arising, and the proceeds of all of the foregoing.

B. The term "General Intangibles" means any personal property of Debtor (including things in action) other than "goods", "accounts", "chattel paper", "documents", "instruments", and "money" as said terms are defined in the California Uniform Commercial Code, whether now existing or hereafter arising, and the proceeds of all of the foregoing. The term "General Intangibles" includes, without limitation, all trade names, trademarks, patents, patents pending, licenses, copyrights, plans, drawings, diagrams, schematics, customer lists, goodwill and tax refunds.

C. The term "Inventory" means all Debtor's goods, merchandise, and other personal property now owned or hereafter acquired, wherever located, which are held for sale or lease, including those held for display, demonstration or out for lease or consignment to be furnished under a contract for service or which are raw materials, work in process, or materials used or consumed, or to be used or consumed in Debtor's business, or which are finished and

unfinished goods, together with all warehouse receipts and other documents evidencing such inventory, and the proceeds of all of the foregoing.

D. The term "Equipment" means all of the Debtor's goods which are used or bought for use primarily in business, and the proceeds of all of the foregoing.

E. The term "Other Assets" means all of the Debtor's interest in deposit accounts, documents, instruments, chattel paper, consumer goods, and farm products, as those terms are defined in the California Commercial Code, and money, and the proceeds of all of the foregoing.

F. The term "Proceeds" includes, but is not limited to, Inventory, returned or reacquired merchandise, Accounts, chattel paper, General Intangibles, insurance proceeds, documents, money, goods, Equipment, instruments and any other tangible or intangible property arising under the sale, lease, exchange, collection or other disposition of the Collateral.

G. The term "Agreement" means this Security Agreement and any amendments or modifications hereof.

3. Subordination of Security Interest

If the Debtor grants a security interest to secure obligations for money loaned to the Debtor by a third party, non related entity (or financial institution) after the date hereof, the Secured Party shall not unreasonably withhold its consent to the new lender's security interest being senior in right to the interest granted under this Security Agreement.

4. Documentation

Debtor shall execute and deliver to Secured Party all documents necessary or convenient to perfect and maintain the security interest granted herein.

5. Obligations Secured

The security interest granted herein shall secure:

(a) Payment and performance of all of the Debtor's obligations to its creditors due and owing as of the date of the meeting of creditors held on [INSERT DATE]; and

(b) All costs expended or incurred by the Secured Party pursuant to the terms of this Agreement, including reasonable attorneys fees and expenses, for the maintenance and/or preservation of the Collateral.

6. Events of Default

The Debtor shall be in default hereunder if:

(a) Any moratorium on collection action is recommended by a committee elected at a meeting of creditors of the Debtor and such committee thereafter revokes such recommendation; or

(b) An event of default shall occur under any agreement for restructuring the Debtor's obligations to its creditors.

7. Remedies On Default

On occurrence of an event of default, or at any time thereafter at which such default is continuing, the Secured Party may enforce any and all of the remedies of a secured party under the California Commercial Code.

8. Miscellaneous

(a) Notices. Any notice required to be given to the Debtor in connection with the

security interest granted hereby shall be in writing and shall be delivered to the addresses set forth below:

To the Debtor:

To the Secured Creditor:

Debtor's Counsel:

(b) Governing Law This Agreement shall be governed by and construed according to the laws of the State of California.

(c) Severability If one or more provisions in this Agreement shall be held to be invalid or unenforceable, then such provisions shall be deemed separable from the remaining provisions of this Agreement and shall in no way affect the validity of any of the other provisions of this Agreement.

This Agreement is dated _____.

"Debtor"

By _____

President

EXHIBIT "B"

STAKEHOLDER'S AGREEMENT

This STAKEHOLDER'S AGREEMENT ("Agreement"), dated as of July ____, 1995, is entered into between (Name of Stakeholder), in its capacity as trustee for the benefit of certain unsecured creditors of [INSERT DEBTOR'S NAME] ("Secured Party"), and the committee of unsecured creditors of [INSERT DEBTOR'S NAME] ("Committee") with reference to the following:

A. [INSERT DEBTOR'S NAME] ("Debtor") on the one hand and Stakeholder as trustee for the benefit of Debtor's unsecured creditors whose claims arose on or before [DATE AS PER SECURITY AGREEMENT] have or will enter into a Security Agreement in the form attached hereto as Exhibit "A" ("Security Agreement"); and

B. Secured Party and the Committee wish to further delineate certain of Secured Party's rights and obligations under the Security Agreement.

NOW THEREFORE, in consideration of the above recitals and subject to the terms and conditions herein contained, the parties hereto agree as follows:

1. Construction. Capitalized terms used in this Agreement and defined in the Security Agreement, shall have the meaning herein as described in the Security Agreement, unless separately defined herein.

2. Limitations on Secured Party's Representations. Secured Party makes no representations as to the value or condition of the Collateral or any part thereof, or as to Debtor's title thereto or as to the security afforded by the Security Agreement, or as to the validity, execution (except CMA's own execution), enforceability, legality or sufficiency of the Security Agreement, and Secured Party shall incur no liability or responsibility in respect of any such matters.

3. Information Respecting Obligations. Whenever it is necessary for Secured Party to ascertain the amount of the indebtedness of Debtor to unsecured creditors for any purpose, Secured Party may rely on a certificate of Debtor so long as such certificate has been reviewed by the Committee and has not be rejected by a majority vote of the Committee, such vote to be taken at a meeting held when at least a majority of the members are present.

4. Notice of Default.

(a) "Notice of Default" as used in this Agreement shall mean a notice delivered to Secured Party signed by the Chairman of the Committee stating that an event of default has occurred under the Security Agreement.

(b) Upon receipt by Secured Party of a Notice of Default, Secured Party shall immediately furnish Debtor with a copy thereof. So long as such Notice of Default is in effect, Secured Party may exercise the rights and remedies provided for in the Security Agreement, subject, however, to the direction of the Committee as provided in Section 4(e) of this Agreement. Secured Party is not empowered to exercise any remedy hereunder or thereunder which requires by its terms that a Notice of Default shall have been first received by Secured Party or be in effect unless it has received a Notice of Default and such Notice is in effect.

(c) A Notice of Default shall become effective upon receipt thereof by Secured Party. A Notice of Default, once effective, shall remain in effect unless and until it is canceled as provided in Section 4(d) of this Agreement.

(d) The Committee shall be entitled to cancel a Notice of Default by delivering a written notice of cancellation to Secured Party before Secured Party takes any irrevocable action to exercise any remedy with respect to the Collateral. Secured Party shall immediately furnish Debtor with a copy thereof.

(e) The Committee shall have the right by one or more instruments in writing executed and delivered to Secured Party, or by oral instruction to Secured Party at a meeting held when at least a majority of the members are present, to direct the time, method, and place of conducting any proceeding by Secured Party or of exercising any power conferred on, or any right or remedy available to Secured Party, or to direct the taking or the refraining from taking of any action authorized by the Security Agreement; provided, however, that (i) such direction shall not conflict with any provision of law or of the Security Agreement and (ii) Secured Party shall be indemnified as provided in Section 4(f).

(f) Secured Party shall not be under any obligation to exercise any of the rights or powers vested in Secured Party by the Security Agreement at the direction or request of the Committee pursuant to this Agreement or otherwise, unless Secured Party shall have been provided an indemnity against the costs, expenses, and liabilities which may be incurred by it in compliance with such request or direction.

5. Limitation on Liability. Notwithstanding any other provision of this Agreement, Secured Party shall not be liable for any action taken or omitted to be taken by it in accordance with this Agreement or the Security Agreement except for its own gross negligence or willful misconduct. In the event of a proceeding under any chapter of title 11 of the United States Code and in accordance with this Agreement, secured party shall continue to take its direction from the Committee, until such time as the Committee is superceded in such title 11 case.

6. Monies. All monies received by Secured Party under or pursuant to any provision of this Agreement or any Security Document (except Secured Party's fees and costs) shall be held for the benefit of the unsecured creditors holding Moratorium Debt, as defined in Exhibit "A" hereto.

7. Notices. All notices or demands by any party hereto to the other party and relating to this Agreement shall be made in writing, delivered either in person with receipt acknowledged or by registered or certified mail, return receipt requested, postage prepaid and to the addresses set forth below:

(a) To Debtor:

and

To Debtor's Counsel:

(b) To Stakeholder and the Committee:

With a copy to Counsel for the Committee:

8. Governing Law and Venue, etc. THE VALIDITY OF THIS AGREEMENT, ITS CONSTRUCTION, INTERPRETATION, AND ENFORCEMENT AND THE RIGHTS OF THE PARTIES HERETO SHALL BE DETERMINED UNDER, GOVERNED BY, AND CONSTRUED IN ACCORDANCE WITH THE INTERNAL LAWS OF THE STATE OF CALIFORNIA, WITHOUT REGARD TO PRINCIPLES OF CONFLICTS OF LAW. THE PARTIES AGREE THAT ALL ACTIONS OR PROCEEDINGS ARISING IN CONNECTION WITH THIS AGREEMENT SHALL BE TRIED AND LITIGATED ONLY IN THE STATE AND FEDERAL COURTS LOCATED IN THE COUNTY OF LOS ANGELES, STATE OF CALIFORNIA. EACH OF THE PARTIES HERETO WAIVES ANY RIGHT EACH MAY HAVE TO ASSERT THE DOCTRINE OF FORUM NON CONVENIENS OR TO OBJECT TO VENUE TO THE EXTEND ANY PROCEEDING IS BROUGHT IN ACCORDANCE WITH THIS SECTION 7.

9. Effectiveness. This Agreement shall be binding and deemed effective when executed by each of the parties hereto.

10. Successors and Assigns. This Agreement shall bind and inure to the benefit of the respective successors and assigns of each of the parties hereto.

11. Severability. Each provision of this Agreement shall be severable from every other provision of this Agreement for the purpose of determining the legal enforceability of any specific provision.

12. Modification; Integration. This Agreement cannot be changed or terminated other than by a document in writing signed by each of the parties hereto. All prior agreements, understandings, representations, warranties, and negotiations, if any, are merged into this Agreement.

13. Headings. Headings of Articles, Sections and Paragraphs have been included herein for convenience only and should not be considered in interpreting this Agreement.

IN WITNESS WHEREOF, the parties hereto have duly executed this Agreement as of the day and year first above written.

Stakeholder, in its capacity
as trustee for the unsecured creditors
of [INSERT DEBTOR'S NAME]

By: _____

Title _____

The Unsecured Creditors Committee of
[INSERT DEBTOR'S NAME]

By: _____

Of _____