SECURED vs. UNSECURED DEBT: SUPPLEMENTAL COMMENTARY TO DAVID GILLER

David Giller, a member of the LinkedIn responded to a question posed on the distinction between secured and unsecured debt. He correctly explained the fundamental principle. His explanation can be found at: http://linkd.in/bZOLSz.

This explanation requires some clarification, although it is correct as far as it goes. It is important for lenders and borrowers to understand the mechanics of the creation of secured vs. unsecured loans, and the important considerations in deciding which loan form makes sense.

A secured debt, as Giller correctly noted, is one in which the borrower's obligation to pay is secured by an asset (such as a vehicle or residence). Typically, but not always, the asset is acquired by the proceeds of the debt. An auto loan is secured by the vehicle purchased with the loan proceeds, and a traditional home mortgage loan is a loan secured by the residence purchased with the loan proceeds. Contrarily, a home equity loan, for example, is also a loan secured by a borrower's interest in residential real estate. The proceeds of such loans, however, are often used for unrelated purposes.

The use of the proceeds of secured debt is largely, but not totally, irrelevant to the matters lenders and borrowers should consider in deciding whether to use secured or unsecured debt.

These matters include:

1. Generally, secured debt is a matter of state law, typically the state's version of the Uniform Commercial Code, and creation of a secured debt requires the borrower to execute two documents: the note for the debt and a security agreement pledging the asset to secure repayment of the debt. (A mortgage is one form of such a security agreement that is now highly regulated by Federal consumer and banking law and regulation. Security agreements remain largely the province of state law, although there is a gloss of Federal consumer protection, banking and other law and regulation. Discussion of these Federal laws and regulations is beyond the scope of this comment.)

[An unsecured debt is created when a lender lends money to a borrower in exchange for the borrower's contractual promise to repay.]

2. Again, generally, while a secured debt is created upon execution of the note and security agreement, a secured debt is only truly or fully effective when the security interest is filed (as provided by state law) so that other lenders are on notice that a particular asset is securing repayment of a debt in a certain amount.

3. Borrowers using assets to secure debt usually receive lower rates of interest or better terms (sometimes the ability to delay repayment of principal for a period, or indefinitely, by making the loan "interest only"). There is a trade off that both parties must - but all too often do not - understand:

(a) The lender is essentially gambling that the value of the asset exceeds the amount of the loan at the time the loan is made, and that the value of the asset will continue to exceed the amount of principal outstanding throughout the term of the loan.

(b) The borrower is essentially gambling that sufficient cash flow will be available to repay the loan (so the borrower has no risk of losing the asset), or the asset securing the loan is one that the borrower can afford to lose if unforeseen adversity renders the borrower insolvent. Losing a piece of commercial real estate or an account receivable may be a reasonable risk for a borrower; losing a residence or only form of transportation is probably not a reasonable risk for a borrower unless ability to repay is absolutely certain.

(c) The lender must understand the borrower's risk calculus. The risk of default where the borrower can sustain loss of the asset without hardship is much greater. Where the borrower can easily sustain risk of losing the asset, the secured debt is basically an investment by the borrower – of the lender's money – and the lender is essentially relegated to looking exclusively to the asset for repayment.

4. The consequences of points 2 and 3 - indeed the significance of secured vs. unsecured debt - become stark if the borrower becomes insolvent. In such case, the lender can use the legal system to acquire the asset to satisfy the debt. Again, there are details that must - but often are not - understood:

(a) If the value of the asset exceeds the amount of the debt (plus expenses of collection), the lender must monetize (sell) the asset and pay over to the borrower the amount by which the asset value exceeds the amount owed.

(b) If the value of the asset is lower than the amount of the debt, the lender will obtain a deficiency judgment against the debtor for the difference between the amount owed and the proceeds of the asset sale.

(c) Importantly, if the lender does not evaluate its risk under point 3(a) well, and the borrower declares bankruptcy, the lender's claim in excess of the asset's value is unsecured and the lender is unlikely to recover the amount of the deficiency.

[In contrast, an unsecured lender faced with an insolvent borrower can obtain a judgment against the borrower for outstanding indebtedness, and can use legal process to have the assets of the borrower (all of those not used to secure other debts and - usually - those that are subject to security interests) monetized to obtain repayment (the traditional "sheriff's sale"), but proceeds from the sale of assets securing other loans will be used first to repay the corresponding secured lenders in full. The unsecured lender only gets amounts in excess of the secured lenders' claims. Again, a borrower's bankruptcy will significantly change the unsecured lender's rights in this regard.]

Bankruptcy - a matter of Federal, not state, law - alters the rights and remedies of secured and unsecured lenders as well as borrowers. It is beyond the scope of this comment. There are also tax ramifications - state and (significantly) Federal - that are beyond the scope of this comment.