# Debt

SECURED AND UNSECURED

- DEBT

- Debt- Obligation to pay back a loan etc.
- Good Debt: Debt that helps you generate income and build your network. Usually, a lower interest rate and debtor believes that this debt will grow in value over time.
- Example: borrowing to invest in a business. Investing in real estate.

- Bad Debt: Items that are not backed by a value increasing asset (property) and the debtor pays high interest rates.
- Example: Credit cards,  car loans, store credits

For businesses look at the debt/credit ratio A/K/A (D/E (QUITY) ratio): shows how much debt a company has compared to its assets. It is found by dividing a company's total debt by total shareholder equity. A higher D/E ratio means the company may have a harder time covering its liabilities.

Shareholders' equity is the amount that the owners of a company have invested in their business.

Invested 100,000 and the amount of debt is 250,000 what is the debt equity ratio? Divide $250,000/100,000 ratio 2:5- the debt outstanding is 2.5 times larger than their equity.

- INCOME STATEMENT
- **Income Statement**: Is a summary of all income(money that coms in) and expenses(money that is paid out) over a period of time.
- Purpose of an Income Statement:
  - Provides the financial story of businesses' operating activities.
    - Frequent Reports:  Income statements are generated monthly or quarterly. Helps business owners track performance and make informed decisions.
    - Pinpoints Expenses: You know where your money is going, and you can budget accordingly.
    - Provides an overall analysis of the company for investors.

- An Income Statements importance lies in helping owners, company leaders, investors, and analyst understand the businesses operational capacity and results. This helps the company become more efficient.

- WHAT GOES ON AN INCOME STATEMENT?
- Revenue: The amount of money a business takes in during a specific period.
- Expenses: The amount of money a business spends during a reported period.
- Costs of goods: The cost component part(s) of what it takes to make whatever a business sells (raw materials, labor, manufacturing overhead costs)
- Gross Profit: Total revenue less cost of goods
- Operating Income: Gross profit less operating expenses
- Income Before Taxes: Operating Income less non-operating expenses

- Net Income: Income before taxes minus taxes
- Earnings Per Share: Division  Divide net income by total number of outstanding share (One million/Shareholders 30%)
- Depreciation: The extent that to which assets have lost value over time.
- EBITDA: Earnings before interest, depreciation, taxes, and amortization.
- Amortization- decrease in amount

HYPO:  Sarah sells ice-cream. Her business earns $12,000 per month. She spends $2,000 on monthly operating expenses and $4,000 per month goes to the cost of goods.

What is her total monthly revenue?
Revenue: Amount business takes in.
What is her operating income?
Operating Income: Gross profit minus operating expenses
What is her gross profit?
Gross Profit: Total Revenue minus cost of goods.

# BALANCE SHEET

The term balance sheet refers to a financial statement that reports a company's assets, liabilities, and shareholder equity at a specific point in time. Balance sheets provide the basis for computing rates of return for investors and evaluating a company's capital structure.

Capital Structure: The distribution of debt and equity that makes up the finances of a company.

# BALANCE SHEET

- A balance sheet reports a company's assets, liabilities, and shareholder equity.
- The balance sheet is one of the three core financial statements that are used to evaluate a business.
- Other two are: Income Statement and Cash flow statement.
- It provides a snapshot of a company's finances (what it owns and owes) as of the date of publication.

# BALANCE SHEET (CONT.)

- The balance sheet adheres to an equation that equates assets with the sum of liabilities and shareholder equity.
- **EQUATION: ASSETS =LIABILITIES +OWNERS' EQUITY**
- Assets (effects of value) must always equal liabilities plus owners' equity.

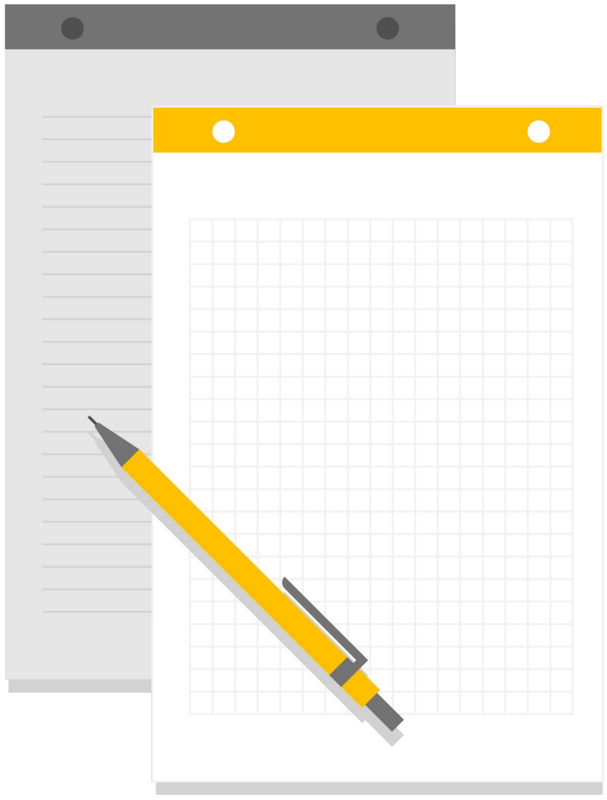
# CASH FLOW STATEMENT

The cash flow statement (CFS), is a financial statement that summarizes the movement of cash and cash equivalents  (CCE) that come in and go out of a company. Examples of Cash Equivalents are Treasury bills, Money Market Funds and Treasury notes.

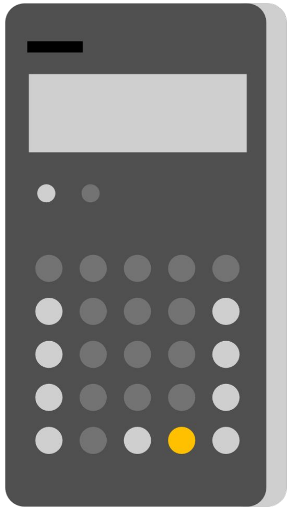
- Treasury bill is debt obligation that is backed by the US Dept. of treasury. Short maturity time.

CASH FLOW STATEMENT (Continued)

- Money Market Funds: type of mutual fund ***that invests in high-quality, short-term debt instruments, cash, and cash equivalents***. Investment so there are no guarantees.
- Treasury Notes: marketable U.S. government debt security with a fixed interest rate and a maturity between two and 10 years
- The Cash flow statement measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses.



- HYPO:
- You are counsel for Company A.  Company A want to merge with Company B. The CEO of Company A hasn't had time to send the financial statements to the finance department for review.  They want you to give them an opinion as to how well Company B manages and generates cash. You would refer to:
  - The balance Sheet
  - The Income Statement
  - Cash flow Statement



- HYPO:

- The same facts as the previous hypo. Now the CEO  is requesting  your opinion on Company B's  business operational capacity. You would refer to:
  - The balance Sheet
  - The Income Statement
  - Cash flow Statement

# WHAT IS SECURED DEBT? WHAT IS UNSECURED DEBT?

Debt: You owe money and must pay it back. Usually acquire debt in the form of a loan.

Why is debt important in business?: Because as your business grows you are going to need cash to buy machinery, products, pay additional staff, rent additional space, etc. Debt can Help you expand your business and establish a credit rating.

- CREDIT RATING

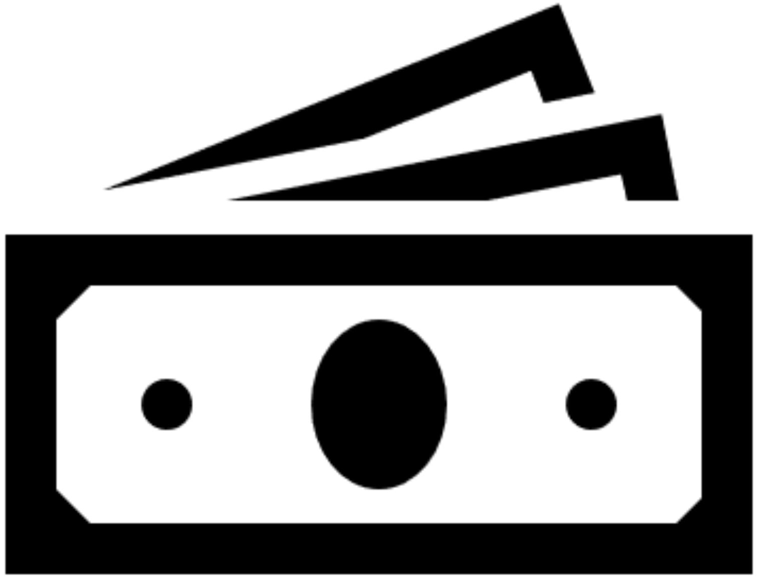
- What is a Corporate Credit Rating? A corporate credit rating is an opinion of an independent agency regarding the likelihood that a corporation will fully meet its financial obligations as they come due. A company's corporate credit rating indicates its relative ability to pay its creditors.

# CREDIT RATING (Continued)

They look at your : payment history, age of credit history, debt and debt usage, industry risk and company size.

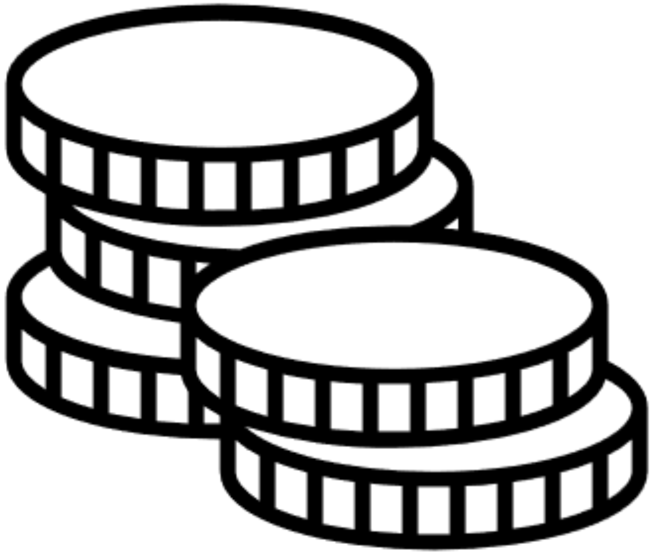
**Fitch Affirms Coca-Cola's IDR at 'A'; Outlook Stable**
Fitch Ratings - Chicago - 24 May 2023: Fitch Ratings has affirmed all ratings for The Coca-Cola Company (Coca-Cola) and its subsidiary, including the Long-Term Issuer Default Ratings (IDR) at 'A', and Coca-Cola's Short-Term IDR at 'F1'. The Rating Outlook is Stable.

**IDR: Income Driven Repayment (payments based on revenue)**
**F1 Rating:** . Indicates the strongest capacity for timely payment of financial commitments relative to other issuers or obligations in the same country.
AAA, AA A, BBB, BB, B, CCC, CC, C, RD, D
Highest rating is **AAA**-lowest expectation of default.
**A- Capacity to pay debts is strong, but vulnerable to business or economic conditions.**



- DEBT (Continued)
- Go to the bank to borrow this money: Once the bank loans you the money  You are in debt:
- Debts can be:
- **SECURED AND UNSECURED**

- **Secured Debt**: Collateral is used.
- Collateral: is something guaranteed or promised as security for repayment for a loan. Example: If I can't pay you back, you can take my prize bull.



## SECURED DEBT (Continued)

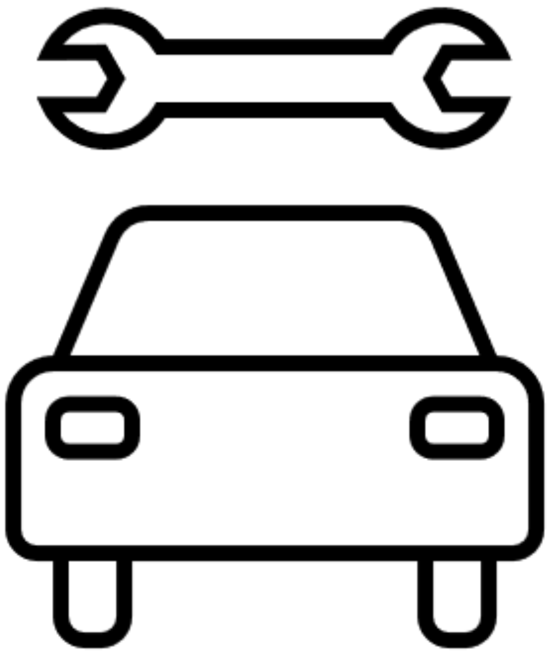
The creditor’s claim to the property is secured by a lien in the debtor’s property by the debtor’s agreeing so or involuntary by the judgement of a particular court. Very common lien in U.S. tax lien.

**Lien**: Claim or legal right to property if debt is not paid or until the debt is paid.

Mortgage borrower don’t need collateral because  if the person can’t pay, the bank takes house. Called foreclosure.

- **UNSECURED DEBT**
- Unsecured debt: Unsecured debt refers to debt created without any collateral promised to the creditor.  Debt associated with credit cards etc. are not connected to any property. Therefore, the creditor risks losing it all, if the debtor becomes insolvent.

- HYPO:
- John buys a very expensive car. He borrows $35,000.00 from the bank. His monthly payments are $1500 for the next 5 years. He loses his job, and he can no longer make the payments. Can the bank repossess the car? Why or why not?



- In reference to the previous car hypo. Would  you say that this car debt is secured or unsecured. Why?

- Remember the value of car decreases substantially as soon as it leaves the lot.

ARTILCE 9 OF THE UCC: deals with **secured** transactions only.

**UCC § 1-201(35)** defines a "Security Interest" as an interest (A RIGHT IN PROPERTY BUT THAT RIGHT IS LESS THAN TITLE) in personal property or fixtures that secures payment or performance of an obligation."  NOT LAND

You borrow money. Personal property you use as collateral is worth $10,000.  The lender has a right to that personal property (what is owed), but it is not his property. He does not  have title to it.

- For a security interest to be **created** under Article 9

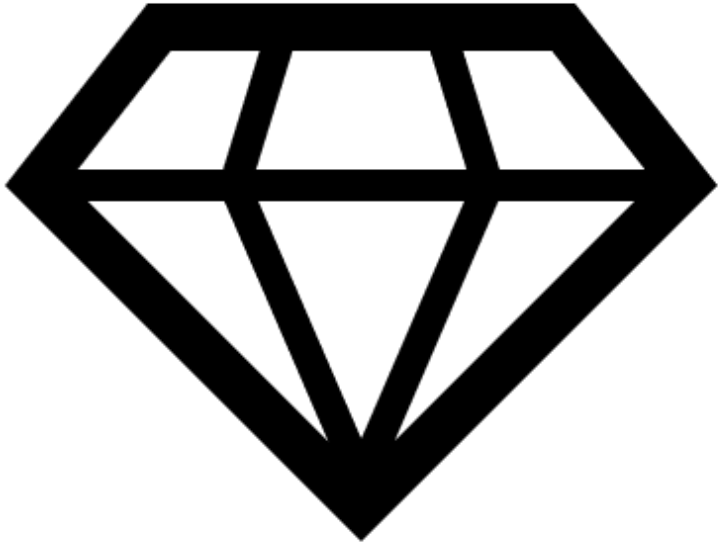
**Value must be exchanged for the collateral :**

1. The debtor must have the rights in the collateral ; 2. and ability to convey rights in the collateral to a secured party;

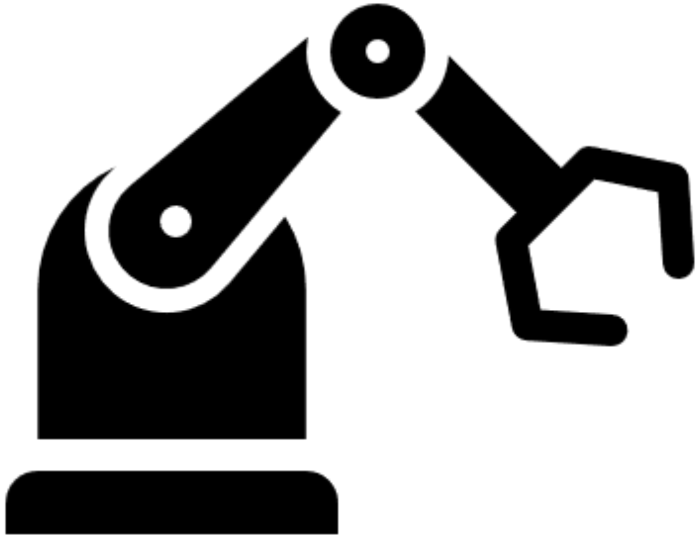
3. and either the debtor must have "authenticated" a security agreement with a description of the collateral or the creditor must be in possession of the collateral.

When all three of these formalities are met, the security interest "attaches" to the collateral and becomes enforceable.

- Article 9 contains a Statute of Frauds component which requires a security agreement to be in writing unless it is pledged. See § 9-203(1) of the UCC. A pledged security agreement arises when the borrower transfers the collateral to the lender in exchange for a loan (e.g., a pawnbroker).



- HYPO:
- Sam owns 30% of machinery in his father’s shop.  He needs a loan to keep his own business afloat. He offers to use 100% of the machinery in his father’s shop as collateral. According to UCC can he do so? Why or why not?



## PERFECTING A SECURITY INTEREST:

A **perfected security interest** is any secure interest in an asset that cannot be claimed by any other party. Secured party has legal right to claim it.

John uses the 30% of his ownership in the machinery in father's shop to get a loan from Local Bank.  He then realizes he needs another loan. He pledges the same machinery as collateral to another lender, Happy Bank. He defaults on his loan with the Happy Bank. Happy Bank wants  to cash out on the machinery. Happy Bank cannot if the first lender has perfected that interest. That is, Local Bank has the legal right to claim the machinery pledged as collateral.

## HOW TO PERFECT A SECURITY INTEREST:

- By filing a financing statement with the appropriate public office
- By possessing the collateral
- By "controlling" the collateral

- Filing a financing statement—is by far the **most common** and important to understand.

- PERFECTING SECURITY (Cont.)- Financing Statement:

- The UCC specifies what must be contained in a financing statement:
  - the name of the debtor
  - the name of the secured party, and
  - an indication of the collateral.
    –Description
  - Must be filed appropriately
  - In New York State fill out a form and pay $40.

# PERFECTING SECURITY (Cont.):

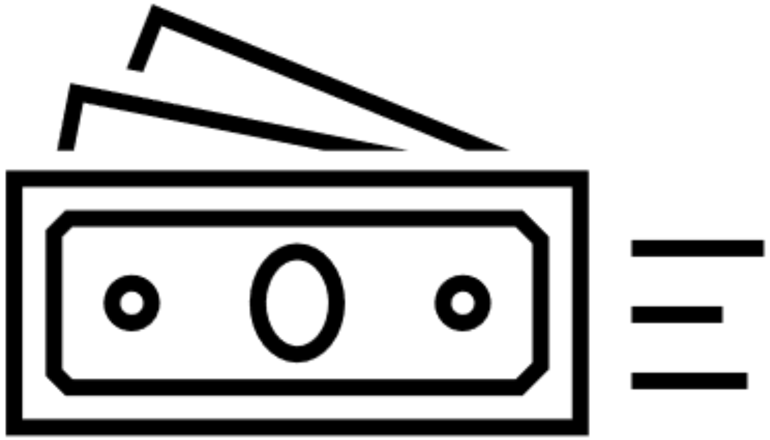
## POSSESSING THE COLLATERAL: TYPES THAT CAN BE POSSESSED

- goods
- negotiable instruments (such as promissory notes and checks)
- money, and
- tangible chattel paper. Ex. Promissory noted coupled with a security agreement.

•WHAT'S YOUR OPINON?

•Anaida wants you to lend her $5,000. She is in debt and needs the money to meet her obligations. She wants to give you a personal check as collateral.

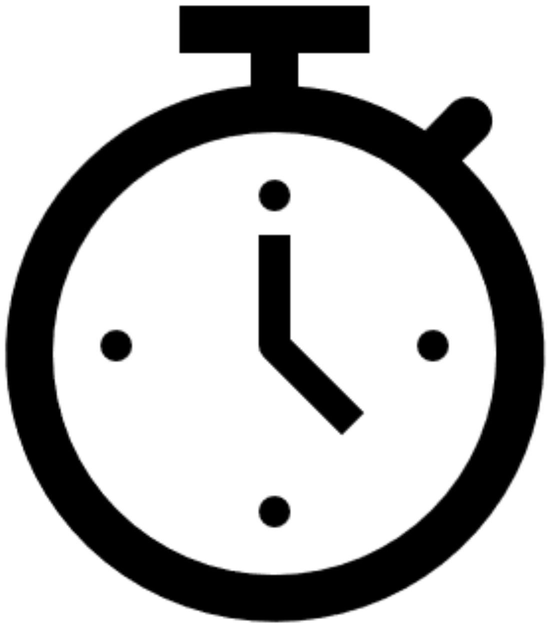
• Would you accept the check? Why or why not?

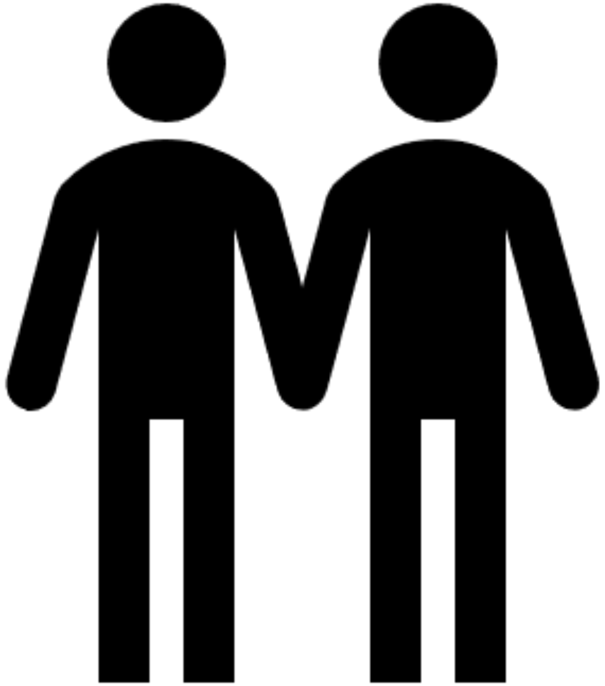


•PERFECTING(Cont.) CONTROLLING THE COLLATERAL: TYPES THAT CAN BE CONTROLLED

- investment property
- deposit accounts
- letter-of-credit right s, and
- electronic chattel paper.

- PRIORITY RULE UNDER UCC ARTICLE 9:
- FIRST TO FILE HAS THE FIRST RIGHT TO THE SECURED INTEREST.
- Joe and Ian have the same security interest in Linda’s property. Joe files and his filing is recorded at 11:00 am. Ian files and his filing is recorded at 11:01 am. Joe is the first to file and has the first right to the security interest if the Linda defaults.





- **Perfected interests can be subordinated with the permission of prior secured parties**.
- Explanation: John offers a certificate of deposit to two creditors; Allen then Bob. The first creditor to  perfect his interest is Allen. Bob files  his interest later.
- John  can’t pay his debt to Bob, but he has paid most of his debt to Allen. Allen can say, okay since he owes you more money than he owes me, you can take possession of the certificate of deposit for the amount that you need.

- **WHAT HAPPENS IF DEBTOR DEFAULTS:**

- Same scenario as above, but now John can’t pay Allen.

- Three Things Allen can do?
  - Foreclose on the collateral- Take possession of a property.
  - Claim a judgement against John- Go to court and declare John in default.
  - Enforce the claim against John. Enforce a claim by going to the Marshall and say “John owes me this property, he is not giving it to me,  go get it for me”.

## IF DEBTOR DEFUALTS A CREDITOR CAN:

- Sell, Lease, License, or Dispose of any of the collateral covered by the security agreement as long as it is reasonable by both parties.
- Creditor must send notice to any secondary lien holder, unless they waive the right to disposition. Ten (10) days deemed sufficient notice.
- All proceeds received over the debt owed must be returned to the debtor or subordinate interest holder.

Allen retrieves and sells the money market account for $150,000. His security interest was only $50,000. Can he keep the remaining $100,000?

***Dispositions that are commercially reasonable.***

A disposition of collateral is made in a commercially reasonable manner if the disposition is made:

(1) in the usual manner on any recognized market;

(2) at the price current in any recognized market at the time of the disposition; or

(3) otherwise in conformity with reasonable commercial practices among dealers in the type of property that was the subject of the disposition.

- HYPO:
- Mary used her two luxury cars as collateral for the loan. Mary defaulted and now her creditor wants to get his money back by using her luxury cars as race cars.
- Creditor can't do this because:
  - Mary doesn’t agree
  - Creditor can do this because the cars are now his property.
  - Creditor can’t do this because using luxury cars as race cars is unreasonable.

- What is Article 9 debt relief?

- Business debt relief under UCC Article 9 can be understood as an alternative to bankruptcy. Unlike a bankruptcy filing, the Article 9 process is out-of-court, does not require lawyers, and is executed as a private negotiation between borrower and lender.

- WHAT’S YOUR OPINON?

- Why do  you think that the Article 9 Process for debt relief is an out of court transaction? Do  you agree?

# CONCLUSION

1. DEBT: GOOD AND BAD DEBT
2. DEBT EQUITY:  HOW MUCH DEBT DOES A COMPANY HAS COMPARED TO ITS ASSETS.
3. FINANCIAL STATEMENTS: INCOME STATEMENT, BALANCE SHEET, CASH FLOW SHEET
4. SECURED AND UNSECURED TRANSACTIONS
5. UCC ARTICLE 9: SECURED TRANSACTION DEALING WITH GOODS AND NOT PROPERTY

## CONCLUSION (Cont.)

6. PERFECTING A SECURITY INTEREST:

- FILING A STATEMENT
- POSSESSING THE COLLATERAL
- CONTROLLING THE COLLATERAL

7.PRIORITY RULE: FIRST TO FILE HAS FIRST RIGHT TO THE SECURITY INTEREST

8.DEBTOR DEFAULTS:

- FORECLOSE
- JUDGEMENT
- ENFORCE THE CLAIM WITH THE SHERIFF

9.DEBTOR RELIEF