

SECURITY INTERESTS UNDER ARTICLE 9 OF THE UCC

A secured transaction is when a creditor takes an interest in a debtor's personal property to secure an obligation owed by the debtor to the creditor. Article 9 of the Uniform Commercial Code (UCC) primarily governs this type of transaction. Article 9 establishes a comprehensive, uniform scheme for the regulation of security interests in personal property. The article also establishes a method for determining and assigning priority among competing creditors with claims or interests in the same collateral. By complying with Article 9, a creditor can determine with reasonable certainty what security interests there are on a given piece of collateral. A creditor can also determine whether its security interest is superior to that of another creditor.

The term personal property, as used in Article 9, means any property that is not real property. Thus, any transaction creating a security interest in any of the following property falls within the scope of Article 9, unless otherwise excluded.

- Goods
- Bills of lading
- Chattels
- Money, merchandise
- Notes
- Bonds
- Stocks
- Warehouse receipts
- Instruments
- Accounts
- Contracts
- Other forms of intangible property

A security interest for purposes of Article 9 is simply “an interest in personal property or fixtures securing payment or performance of an obligation.”

Creating a Security Interest

When making a loan to be secured by personal property, the lender can create a valid and enforceable security interest in the collateral by following these requirements:

- There must be a written security agreement containing a description of the collateral (if crops or timber, the description should include the land involved). The debtor must sign the written security agreement; or the collateral must remain in the possession of the secured party (possessory security interests have their basis in the old adage that possession is 9/10ths of ownership).
- The secured party must have given value to the debtor, which may be either an advance of funds or a binding commitment to do so.
- The debtor must have rights in the collateral. Ownership is not the only right that one can have in a property. A debtor may have “use rights” to property for a specified time or have rights to the earnings of property, such as money, stocks or bonds, but not the underlying items themselves. In any transaction, the lender should consider what rights a debtor has in property being offered as collateral for a loan.

Upon satisfying the foregoing requirements, a lender attaches a security interest to the property offered as collateral and that interest becomes enforceable by law. The description need only “reasonably identify what is described.” Lack of specificity will not penalize a creditor, but the more specific the description in identifying the collateral, the better.

Because the creation of a security interest in property concerns only the parties to that transaction, there may be more than one security interest in a particular piece of collateral. As a result, since a debtor will likely have possession of the collateral, a creditor must be concerned with the sale of the collateral to another party. These possibilities create issues of priority for creditors against other parties with interests in the same piece of collateral. Once a creditor creates a valid and enforceable security interest, a creditor may perfect that interest as the next step under Article 9 as protection from third parties with competing claims or interests.

Perfecting a Security Interest

A creditor may perfect a security interest in one of three ways, each with its own special considerations:

- Automatically.
- By taking possession of the collateral.
- By filing a financing statement at the public office designated by state law.

We discuss each of these three methods below in more detail.

Automatic Perfection

A creditor will automatically perfect a security interest, without the necessity of filing a financing statement or taking possession in the following situations, subject to any conditions noted therein:

- A security interest in instruments and documents for up to 21 days or cash proceeds from disposition or sale of collateral for ten days after such disposition or sale. This provision reduces cluttering of public offices with filings on transactions that occur frequently and are short-term. Further, this provision allows continued business without substantial interruption or delay.
- A security interest created by assignment of a beneficial interest in a trust or deceased person's estate.
- A purchase money security interest in consumer goods to the extent that the seller retains such interest in the collateral to secure all or part of the purchase price. Also, where another party advances money to the seller in return for an assignment of chattel paper from the buyer that enabled him to purchase the goods.

NOTE: Refinancings, loan consolidations and other forms of restructurings that extinguish the original loan will destroy a purchase money security interest. This is because the proceeds of the "new" loan are not used to acquire rights in the collateral. When loaning money to be secured by consumer goods, lenders should exercise particular caution to determine whether the goods are subject to a purchase money security interest. As no filing is required to perfect such an interest, a simple check of local records will be ineffective.

- An assignment of accounts that does not alone or in conjunction with other assignments to the same assignee transfer a significant part of the debtor's accounts.
- A security interest of a collecting bank in checks and other items, including securities, that are being collected or created or covered by other parts of the UCC.
- An assignment made for the benefit of all the creditors of the transferor and subsequent transfers by the assignee thereunder.

One can also provide automatic perfection by certain other filing or registration systems to which the UCC defers (for example, certificates of title for automobiles). The law treats satisfaction of the requirements of these systems as the equivalent of filing a financing statement under the UCC.

Possession

A creditor may perfect a security interest in property through possession, which does not require a written security agreement signed by the debtor. However, since possession of the goods must occur voluntarily, an agreement is preferable and recommended as evidence of such. Additionally, a written security agreement will operate to reduce subsequent disputes between the parties over the terms of the transaction. The creditor may handle the possession directly or through an agent.

There are certain kinds of collateral in which the creditor cannot perfect a security interest by possession. These are: goods, checks, negotiable notes, instruments, money, negotiable bills of lading, negotiable warehouse receipts and chattel paper.

Once a creditor perfects a security interest by possession, the security interest continues only for as long as the secured party retains possession or perfects the interest some other way, such as filing a financing statement.

Creditors generally do not favor perfection by possession due to the duties imposed upon the creditor as the secured party. However, in the case of money, possession may be the only effective means given its fungibility. When in possession of collateral, a secured party must use reasonable care to protect and preserve the collateral. In the case of negotiable instruments, securities and chattel paper (leases or other obligations to pay money to the debtor that the debtor has pledged as security by the debtor for a loan), reasonable care includes taking steps to preserve the debtor's rights against prior parties. This may include collecting periodic interest, taking steps to collect instruments preserving rights against parties secondarily liable on the instrument, and taking other steps to maintain the value of the collateral.

A creditor's failure to exercise reasonable care for collateral in its possession will not cause the creditor to lose its security interest. However, a secured party is liable to the debtor for any loss or damage caused by its failure to exercise reasonable care. If the property in possession of the secured party generates monetary profits, the secured party must either apply the money to reduce the obligation owed or remit the money to the debtor. The secured party may retain all other types of profits as additional security.

Filing of a Financing Statement

The UCC requires secured parties to file a financing statement to perfect security interests in certain types of collateral. The statement provides creditors, buyers, or other third parties who deal with the debtor notice of the security interest.

The first step in perfecting a security interest is a financing statement. It is this document that the creditor must file to obtain perfection. Typically, a financing statement differs from the security agreement. Yet a security agreement can qualify as a financing statement if it meets all the following UCC requirements:

- Includes the names of the debtor(s) and the secured party.
- Is signed by the debtor(s).
- Gives an address for the secured party where information about the security interest may be obtained.
- Gives an address for the debtor.
- Contains a statement indicating the types or describing the items of collateral.

To complete perfection, a secured party must file the financing statement in the appropriate place. It is here that the greatest amount of diversity about the UCC exists among states. The appropriate place for filing a financing statement depends upon the following factors:

- Type of collateral involved.
- The specific UCC filing provision adopted by each state.
- Any local modifications made to the UCC rules.

An institution should consult with legal counsel before entering into any secured transaction where institution personnel are not certain of the appropriate filing requirements.

Priorities

As previously noted, Article 9 was established, in part, to determine and assign priority among creditors with competing security interests in the same collateral. Article 9 provides for the perfection of security interests, and rewards those who do so with certainty as to their priority over other creditors and third-party purchasers. The creditor who fails to perfect its security interest in a debtor's collateral will be vulnerable to claims and interests of other creditors, purchasers or transferees.

Unperfected Security Interests

Unperfected security interests are inferior to the following interests:

- Secured parties with perfected security interests (even if they have knowledge of the unperfected interests).
- Lien creditors who obtain a lien against the property before perfection of the unperfected security interest.
- Buyers of collateral who give value and receive delivery without knowledge of the unperfected security interest, and before it is perfected, when the collateral in question is goods, instruments, documents, chattel paper, or farm products. Buyers of farm products must be buyers in the ordinary course of business.
- Buyers who purchase goods in the ordinary course of business.
- Buyers of consumer goods who purchase without knowledge of the unperfected security interest, for value and for their own personal use.
- Good-faith transferees of accounts and general intangibles.

Perfected Security Interests

In some cases, collateral may be subject to more than one perfected security interest. The general rule of the UCC is that priority goes to the first to file a financing statement or perfect a security interest. UCC filings are date- and time-stamped to clearly show the order of perfected liens. Remember that perfection does not always require the filing of a financing statement. In a situation where one creditor filed a financing statement to perfect a security interest, and another simply took possession of the collateral, if the latter creditor took possession prior to the filing of the financing statement by the first, the latter creditor will have priority.

The UCC highly favors purchase money security interests and gives them special treatment. For example, a person with a purchase money security interest in collateral that is anything other than inventory has priority over any other person with a conflicting security interest. The security interest must be perfected no later than ten days after the debtor's receipt of the collateral. As previously noted, purchase money security interests in consumer goods are automatically perfected without the need to file a financing statement. Concerning other types of collateral, however, creditors accomplish perfection by filing a financing statement. Notably, a perfected purchase money security interest will have priority over a previously existing perfected security interest, such as where a creditor has an after-acquired property clause in a previously existing arrangement.

Concerning inventory, a purchase money priority does exist. This priority includes any identifiable cash proceeds. However, a secured party must take the following steps to avail itself of such priority:

- Perfect the interest at the time the debtor receives possession of the inventory.
- Give written notice to holders of conflicting security interests perfected by the filing of a financing statement.
- Describe the collateral in the written notice and indicate that the party expects to acquire a purchase money security interest in such collateral.

Buyers in the Ordinary Course of Business

Special priority also exists for purchasers of goods who bought them in the ordinary course of business. Such buyers take free of any security interest that a seller created or gave in such goods, even though the security interest is perfected and its existence known by the buyer. Notably, the UCC requires that the seller be one who is in the business of dealing in goods of the kind purchased by the buyer.

Leases

Article 9 governs transactions where a security interest is intended or occurs regardless of whether the documents themselves state that a security interest exists. One example of where this comes into play concerns leases. When a lease functions like a security transaction, it is subject to Article 9 even though the lease may not specifically state that it creates a security interest under Article 9. The terms of the lease determine whether a lease constitutes a security transaction subjecting the lease to provisions of

Article 9. Leases that do not qualify for treatment as secured transactions fall under Article 2A of the UCC. The discussion below concerns only those leases subject to Article 9.

Leases are an alternative to purchasing an item on credit terms. The lease provides that the lessee can enjoy the item during its useful life. The lease also provides for deferred payment similar to an installment purchase or conditional sales plan. The lease may provide that the lessee will assume the burdens, normally assumed by an owner, of maintaining and insuring the item being leased. The lease may also provide that the item will become the property of the lessee, for little additional payment, at the end of the lease. In such cases, it is reasonable to view the lease as a security transaction. The lessor is regarded as the secured party; the lease agreement is treated as the security agreement; and the lessee is regarded as the debtor. The result of such an arrangement is that the transaction will be subject to the UCC's requirements for perfection of security interests and treated accordingly as to priority over other creditors. Additionally, the UCC's provisions will apply on remedies when there is a default.