Secured transactions

Commercial transaction class Lecture 4.01

Introduction

Setting

- A creditor wishing to protect itself will often take a security interest in collateral belonging to the debtor
- Secured transactions are governed by Article 9 of the UCC
- Without security in the form of collateral, lenders become unsecured creditors who have a low priority during bankruptcy
- The collateral used by an individual or business to secure a loan must fit within one of the categories specified under Article 9

Objective

- Today we examine Article 9, its terminology, and its operations. After this lecture, you should be able to answer the following questions:

1. What are the important definitions associated with secured transactions?
2. How are secured interests created?
3. What does it mean to perfect a security interest?
4. What is the purpose of perfection?

Classifications of collateral in a secured transaction

What is a secured transaction?

- Secured transactions involve a financing agreement between a lender (creditor) and a borrower (debtor)
  - in which the borrower pledges its assets as collateral to secure the loan
- Secured transactions may induce a lender to loan money where it would not have done so if limited to contractual remedies
  - otherwise, the lender would have the status of 'unsecured creditor'

Categories of collateral

- Goods subject to a security interest would fall within one of these categories
  - Consumer goods (Items used for personal, family, or household use, such as appliances, jewelry, artwork, and automobiles)
  - Farm products (Seeds and crops)
  - Inventory (Items manufactured by a business intended for sale)
  - Equipment (Machinery used to produce goods, or devices that support business operations, such as computers)

Other categories of collateral

- Financial products (Negotiable instruments and checking accounts)
- Intangibles (Intellectual property-patents, trademarks, and copyrights)

A security interest can cover property other than that in the debtor's possession

A security interest will apply to collateral in the debtor's possession

- A security interest can reach other types of property
  - Proceeds
  - After-Acquired Property
  - Future Advances
  - Floating Lien

Proceeds

- Money or other valuable assets received when collateral is sold or otherwise disposed of.
- Proceeds include whatever is received when collateral is sold or disposed of in some other way

After acquired property

- Property acquired by the debtor after the execution of the security agreement
- After-acquired property is property that the debtor acquired after the execution of the security agreement
- This is useful for inventory financing arrangements

Future Advances

- Withdrawals against a line of credit are subject to a properly perfected security interest in the same collateral that secures the initial loan
- A line of credit allows a debtor to borrow intermittently
- Advances against lines of credit can be subject to a properly perfected security interest
- Cross-collateralization occurs when an asset that is not the subject of a loan is used to collateralize that loan

The Floating Lien

- A security interest in collateral that is retained even when the collateral changes in character, classification, or location
- Floating liens commonly arise in the financing of inventories
- The floating lien can apply to a shifting stock of goods

Two steps must be followed to create a valid security interest

The first step is to create an agreement or contract with the lender that defines and creates a security interest

- Security interests are used to secure the payment of an obligation
- Security interests on the property used as collateral can be narrowly defined or very broadly defined
- A security interest can include items beyond the initial collateral

The second step is to attach a security interest to property

- This is achieved when value has been given, the debtor has rights in the collateral (usually possession and usage rights), and a security agreement has been executed by the parties
- An oral agreement is allowed in some jurisdictions, however, the most prudent thing to do is execute the security agreement in writing signed by both parties

Once the requirements are met, the creditor's rights attach to the collateral

- Attachment requires three things
  - value has been given
  - the debtor has rights in the collateral
  - the debtor has authenticated a security agreement that describes the collateral
- Attachment gives the creditor an enforceable security interest in the collateral

A valid security agreement generally travels with the collateral

- A creditor's interest in the collateral remains even if the property is sold
- Major exception is the buyer in the ordinary course of business
- A buyer in the ordinary course of business can purchase goods free of a pre-existing security interest
  - This problem often arises in the the context of a security interest in inventory
- Case discussion: *Morgan County Feeders, Inc. v. McCormick*, 836 P.2d 1051 (Colo. Ct. App. 1992)

Perfecting a security interest

A secured party wants to have priority over other secured lenders who may also have overlapping security interests in the same property

- Lenders will protect their priority by perfecting the security interest
- Perfecting a security interest may give a lender priority over other secured lenders
- A lender cannot simply rely on attachment

There are four main ways to perfect a security interest to protect from overlapping claims

Perfection by filing

- Secured lenders may file a UCC-1 Financing statement with the Secretary of State where the borrower resides
  - These typically last 5 years and may be renewed.
- Goods, equipment, inventory and financial products (except deposit accounts) may be perfected in this manner
- Certain intangibles such as patents and trademarks must be perfected in this manner

Perfection by possession

- This method may be used for certain tangible and movable items such as artwork or jewelry
  - Pawn shops use this method
- The priority date is the date the creditor takes possession

Perfection by control

- Certain financial products and accounts, such as securities, can be perfected through control
- The secured lender aquires control when it is in position to have the securities
- The control is achieved through a custodian or transfer agent

Automatic perfection

- A purchase-money security interest (PMSI) automatically perfects
- The purchase money security interest generally does not need filing to perfect
- A purchase money security interest arises under specific circumstances
- A purchase money security interest in consumer goods automatically perfects **at the time of sale**

Perfection must be maintained or it will lapse

A financing statement is only effective for a limited period of time

- A financing statement is effective for five years from the date it is filed

Priority among creditors' claim to collateral

Multiple parties may have a security interest on the same property

- The general rule is that whoever perfected the security interest first or filed a UCC-1 statement has priority.
- First in time = first in right

The general ranking of claims is

- PMSI
- First to perfect a security interest
- Secured lender without a perfected security interest
- Unsecured lender

The consequences of a borrower's default

A borrower who breaches a contract with the lender is said to be in default

- Often, a security agreement will define the various occurrences that will trigger a default
- In practice, creditors typically seize collateral only as a last resort
    - Lenders typically do not seek to immediately repossess the property but rather seek to refinance or find an alternative solution

A secured lender may repossess the collateral

- A secured lender may decide to seize the collateral through a judicial action or by contracting with a repo agent service
- If a creditor contracts with a repo agent service, the repossession must be done in a way that does not breach the peace

Conclusion

What did we learn today?

- The concept of the security interest lies at the core of secured transactions law
- Perfecting a security interest protects secured creditors from other creditors
- There are different means of perfection
- Perfection must be maintained or it will lapse