

Secured Transactions

A secured transaction is an agreement by which the secured party (someone who is owed money) obtains a security interest in the personalty (collateral) of the debtor. Accordingly, debt secured by such personalty often is referred to as “collateralized” debt.

UCC Article 9 applies to **consensual, secured transactions in personalty**.^a In order for Article 9 to apply to a specific situation, the debtor must agree (consensual) to allow the creditor to have a security interest (secured) in personal property that is financed by a debt.

Every consensual secured transaction has five components in it:

- 1) **Debtor**,
- 2) **Secured creditor**,
- 3) **Collateral** – the personal property of a debtor subject to a creditor’s security interest,
- 4) **Security agreement**, and
- 5) **Security interest** – this is a **creditor’s right to a debtor’s personal property**. This right exists to protect the creditor’s right to payment. In the event of the debtor’s default and nonpayment on the debt, the secured creditor may repossess the collateral (and in some cases liquidate collateral) to satisfy the debtor’s obligation.

Additional Issues Connected to Collateral

Usually, the collateral property is something that is obvious and tangible such as equipment or a car. There are some other terms connected to collateral that you need to be familiar with that arise in some situations.

An **after-acquired-property clause** is often included in a security agreement to allow the creditor to obtain an interest in collateral property that is acquired by the debtor at a later date. This is most often used when a store pledges **future inventory** as collateral. This clause is necessary because the inventory that the store has had on hand at the time of the agreement will not remain on hand for long as it is sold to customers. Therefore, the creditor needs to ensure that they will still have collateral even after the original inventory has been sold.

If a debtor should sell the collateral property that is subject to a security agreement, then the creditor has a right to the proceeds from such a sale. This is called a **security interest in proceeds** and it is an automatic right of the creditor, and the right applies unless it is expressly excluded in the security agreement.

Example: Bill’s Hardware Store obtains a loan from Second National Bank. As collateral, Bill pledges all current and future inventory until the loan is repaid.

The future inventory is an example of the after-acquired-property clause.

^a Debt secured by realty is known as a **mortgage**. Mortgages are beyond the scope of UCC Article 9.

A PMSI Creditor

A **purchase money security interest (PMSI) creditor** is a specific type of creditor that has more (or better) rights to the collateral property than a creditor that is not a PMSI. There are two ways through which a creditor becomes a PMSI creditor and these two ways are through the source of the money that was used to buy the collateral property. Essentially, if the money that was loaned by the creditor is used to purchase the collateral property, the creditor is a PMSI creditor.

Technically, the two situations in which the creditor becomes a PMSI creditor are:

- 1) The debtor borrows the money from the creditor and uses that money to purchase the collateral property from another party (a **car loan obtained from a bank**), or
- 2) The debtor obtains the collateral property directly from the creditor, with the promise of later payment (a **“credit sale”**, or a **car loan obtained from the car dealer directly**).

Either of these methods almost always results in the creation of a **PMSI creditor**. As long as the lender or seller described above retains a security interest in the specific goods that were purchased by the debtor, then the lender or seller is a PMSI creditor.

Note: If the debtor uses **previously owned property as the collateral**, the creditor will not become a PMSI creditor because the money loaned was not used to purchase or acquire the collateral.

The distinction of whether or not the creditor is a PMSI creditor is important because it will impact the rights of different parties in case the debtor defaults. We will see the term PMSI creditor again later.

Note: PMSI Creditor Securities relate only to the **sale of consumer goods to consumers**. In this case, perfection (discussed later) takes place automatically when the requirements for attachment are met. If the sale is to other retailers or wholesalers, the only way to perfect is through filing. (Attachment and perfection are discussed in the following sections.)

Example: John wants to purchase a new car, but he has insufficient cash to buy the car outright. He goes to First National Bank and obtains a new car loan for \$14,000.

In this case, First National Bank is a PMSI creditor, and the loan is collateralized by (First National's interest is secured by) the new car.

Example: Hank wants to take out a loan from First National Bank to do some home improvements. He has fully paid for a car worth \$18,000, and he pledges this car as collateral for the home improvement loan.

In this case, there is no PMSI creditor because Hank used his own collateral property that he already owned to secure the loan; he did not use the creditor's money to purchase the property that was used as the collateral.

Example: Hank purchased a new computer on account from Circuit City, a local department store. Hank will make 24 monthly payments for the computer.

In this case, Circuit City is a PMSI creditor. This fact pattern ALWAYS results in a PMSI creditor because it is an example of a credit purchase.

This next section of the material deals with Attachment and Perfection. These are the terms for the different steps in the process that the creditor must follow in order to make their claim to the collateral better than anyone else's claim to the same collateral. These steps are necessary because it is possible for the debtor to give the same property as collateral to more than one creditor. In the case of the debtor's default on these debts collateralized by the same property, there must be a mechanism to determine which creditor has first claim to the property, who has second claim, and so on. These mechanisms are attachment and perfection. As a brief introduction, there are three classifications of creditors based on their claim to the collateral property. These are:

- 1) Unsecured,
- 2) Attached, and
- 3) Perfected.

This is looked in much more detail in the materials following, but in short, a creditor that is perfected has priority over a creditor that is attached. And an attached creditor has priority over an unsecured creditor. This means that a creditor will want to perfect their interest as quickly as possible to be certain that if the debtor defaults, they will have the first claim on the property that is used as the collateral.

An unsecured creditor is a creditor that has an interest in the collateral property, but this interest is a very weak one and the unsecured creditor will lose the collateral property to any creditor who is either attached or perfected. Also, an unsecured creditor will not be able to force the debtor to sell the property in settlement of the debt.

Our attention will be focused on the process of attaching and perfecting the creditor's security interest. We will look first at the process of attachment and then perfection. We will finish this section by looking at the process of what determines the priority of creditors when there is more than one creditor who has attached or perfected.

Attachment

Attachment must occur in order for a creditor's security interest to be **enforceable against the debtor**. This means that until the creditor has attached his or her security interest, the debtor will not be required to give the collateral to the creditor in the case of default by the debtor.

Once attachment occurs, the creditor is protected against the default of the debtor in that if the debtor defaults, the creditor will have some recourse against the debtor. However, attachment does not protect this creditor against claims that parties other than the debtor (other creditors, for example) might also have on the property. This means that an attached creditor may not get the collateral if there is another creditor with a better claim to the collateral property.

There are three requirements that **must all occur** in order for attachment to occur:

- 1) There must be a **consensual security agreement (usually must be written)** between the debtor and creditor that creates a security interest. A written agreement must be signed by the debtor (this indicates their consent to the security interest be given to the creditor) and must contain a description of the collateral. The collateral may be after-acquired goods. This means that the company may use as collateral items that they do not own at that moment in time (inventory and fixed assets would be common examples of this).

Note: An **oral agreement only is sufficient in the case of pledges**. These are situations in which the creditor actually holds, or **has possession of** the debtor's collateral.

- 2) **The creditor must give value**. However, it need not be present value. The value that the creditor gives may be from an antecedent (preexisting) debt.

- 3) **The debtor must have rights in the collateral.** In order to be able to give something as collateral, the debtor must have a right in that object. Having a right is different from having title, however. In the example above regarding the purchase of the car, the buyer has right to the car even though title will remain with the bank until the loan is paid.

Normally, the debtor cannot have rights in the property until they actually have possession of it. This means that attachment may not occur when the property has only been ordered by the debtor. Usually the debtor must have received the property before attachment can occur.

Note: There is no right in timber until trees are cut and processed, and no right in minerals until they are extracted from the ground.

A creditor who has attached is called a **secured creditor**.

Example: Charlie needed cash, so he pawned his saxophone at Sam's Pawn Shop for \$200. Charlie orally agreed to repay \$210 in 60 days in exchange for the return of his saxophone, and Sam agreed. Has attachment occurred?

This constitutes a pledge, and so even though there is no written agreement attachment has occurred since the Pawn Shop has possession of the saxophone.

Example: On January 1, Dan borrowed \$500 from Third National Bank to purchase a new cash register for his store. He signed a promissory note and a security agreement with the bank on January 1. On January 20, Dan bought the cash register. When did attachment occur?

Attachment occurred on January 20, since Dan did not obtain rights in the collateral until January 20.

Note: When an agreement is required to be in writing under the UCC Chapter 9 Secured Transaction provisions, only the **debtor's** signature is required. The creditor's signature never is required because the instrument will be enforced against the debtor.

Question 62: Under the UCC Secured Transactions Article, which of the following events will always prevent a security interest from attaching?

- a) Failure to have a written security agreement.
- b) Failure of the creditor to have possession of the collateral.
- c) Failure of the debtor to have rights in the collateral.
- d) Failure of the creditor to give present consideration for the security interest.

(CPA Adapted, May 1994)

Question 63: On March 1, Green went to Easy Car Sales to buy a car. Green spoke to a salesperson and agreed to buy a car that Easy had in its showroom. On March 5, Green made a \$500 down payment and signed a security agreement to secure the payment of the balance of the purchase price. On March 10, Green picked up the car. On March 15, Easy filed the security agreement. On what date did Easy's security interest attach?

- a) March 1.
- b) March 5.
- c) March 10.
- d) March 15.

(CPA Adapted, May 1993)

Perfection

Perfection is the second step in securing rights against property of the debtor. Being perfected is preferable to being attached because perfection protects the creditor against the claims on the property by other creditors who are not perfected.

Effect of Perfection

The security agreements in place during attachment bind the debtor and secured party (creditor) immediately. However, these security agreements do not protect the creditor against other creditors who may also lay claim to the same asset. Once the creditor **perfects** his interest in the property, they do have protection against many (but not all) other parties who may have claim to that property. Perfection is essentially the process of the creditor informing everyone else that he has a security interest in the property.

Once the creditor perfects his interest, he is protected from competing third-party claims against the collateral, including those who buy the collateral from the debtor. Thus, perfection is a creditor's protection from other creditors.

Methods of Perfection

Creditors may perfect their interests through any of the following three methods:

- 1) **By taking possession of the collateral property with the debtor's agreement.** When the creditor takes possession of the collateral, there is simultaneous attachment and perfection. Any competing claim for the collateral must go through the possession creditor.

Note: With money or instruments, possession is the only method available for perfection.

- 2) **By publicly filing a financing statement.** A financing statement is **constructive notice** to third parties (even subsequent consumer buyers without actual notice of the security agreement are considered to have been notified) that a security interest exists in collateral. This filing typically takes place at a county courthouse.

63 c – The attachment cannot occur until the debtor has an interest in the property, and that did not occur until Green picked up the car.

A valid financing statement has three elements:

- a) **Names and addresses** of the debtor and creditor,
- b) The **debtor's signature**, and
- c) A **general description** of the collateral property.

Financing statements are valid for **five years** and can be renewed for another five years. This type of renewal can occur indefinitely.

Note: **A PMSI creditor has 10 days after attachment to file a financing statement.** If the PMSI creditor files the financing statement within 10 days of attachment, he or she will have priority over other secured creditors. This is covered again in more detail later.

Note: For receivables, contract rights, and other intangible assets, filing is the only way that a creditor can perfect his interest. This is because there is nothing tangible to possess.

- 3) **By attachment, in some situations.** PMSI creditors in **consumer goods** are perfected automatically once attachment has occurred. A sale in consumer goods means that the sale is made to a consumer. This means that they are not required to file a financing statement and do not need to take possession of the collateral in order to perfect their interest **if the sale is made to a consumer.**

Perfection by attachment **protects the PMSI creditor against all subsequent creditors.**

However, **perfection BY ATTACHMENT ONLY is ineffective protection against a consumer** who purchases the good that is also acting as collateral from the debtor without notice of the security interest. In order to be protected against a consumer (an unknowing third party), the PMSI creditor must also file a financing statement. The financing statement functions as constructive notice to **all parties**, including consumers.

Example: Juan buys a television on account from Sears Department Store (with Sears becoming a PMSI creditor in consumer goods). Attachment and perfection occur simultaneously (Sears is not required to file a financing statement) because Sears is a PMSI creditor in consumer goods. Juan immediately sells the television to Bill, and Juan then flees the country. Sears tries to repossess the television from Bill, an individual who purchased the television for his own use and without notice of the security interest between Sears and Juan. Will Sears succeed in its repossession attempt?

No, Sears will not be successful in its repossession attempt. However, if Sears had filed a financing statement, then Sears would prevail over Bill and thus would be entitled to repossess the television. This would be true even if Bill had no actual knowledge of the security interest between Sears and Juan because the process of filing creates constructive knowledge by third parties.

Question 64: Mars Inc. manufactures and sells VCRs on credit directly to wholesalers, retailers and consumers. Mars can perfect its security interest in the VCRs it sells without having to file a financing statement or take possession of the VCRs if the sale is made to:

- a) Retailers.
- b) Wholesalers that sell to distributors for resale.
- c) Consumers.
- d) Wholesalers that sell to buyers in the ordinary course of business.

(CPA Adapted, May 1993)

Question 65: Which of the following transactions would illustrate a secured party perfecting its security interest by taking possession of the collateral?

- a) A bank receiving a mortgage on real property.
- b) A wholesaler borrowing to purchase inventory.
- c) A consumer borrowing to buy a car.
- d) A pawnbroker lending money.

(CPA Adapted, May 1993)

Question 66: Under the UCC Secured Transactions Article, what is the effect of perfecting a security interest by filing a financing statement?

- a) The secured party can enforce its security interest against the debtor.
- b) The secured party has permanent priority in the collateral even if the collateral is removed to another state.
- c) The debtor is protected against all other parties who acquire an interest in the collateral after the filing.
- d) The secured party has priority in the collateral over most creditors who acquire a security interest in the same collateral after the filing.

(CPA Adapted, November 1992)

Relocating Collateral

If collateral is perfected in one state and is then subsequently moved to another state, the perfection that was achieved in the **first state remains intact in the second state for four months after the collateral is moved**. Before the four-month period expires, the creditor who perfected in the first state must take additional steps to perfect the collateral in the new state in order to retain their protection against other creditors. If they do not, they lose their perfected status in the collateral.

64 c – In sales made to consumers, the PMSI creditor does not need to file a financing statement in order to perfect.

65 d – When a pawnbroker takes possession of the collateral, they are perfecting their interest in it by taking possession.

66 d – Once a security interest is perfected by filing, the creditor will maintain a superior claim over most subsequent creditors who acquire an interest in the property.

Question 67: Larkin is a wholesaler of computers. Larkin sold 40 computers to Elk Appliance for \$80,000. Elk paid \$20,000 down and signed a promissory note for the balance. Elk also executed a security agreement giving Larkin a security interest in Elk's inventory, including the computers. Larkin perfected its security interest by properly filing a financing statement in the state of Whiteacre. Six months later, Elk moved its business to the state of Blackacre, taking the computers. On arriving in Blackacre, Elk secured a loan from Quarry Bank and signed a security agreement putting up all inventory (including the computers) as collateral. Quarry perfected its security interest by properly filing a financing statement in the state of Blackacre. Two months after arriving in Blackacre, Elk went into default on both debts. Which of the following statements is correct?

- a) Quarry's security interest is superior because Larkin's time to file a financing statement in Blackacre had expired prior to Quarry's filing.
- b) Quarry's security interest is superior because Quarry had no actual notice of Larkin's security interest.
- c) Larkin's security interest is superior even though at the time of Elk's default Larkin had not perfected its security interest in the state of Blackacre.
- d) Larkin's security interest is superior provided it repossesses the computers before Quarry does.

(CPA Adapted, May 1994)

Priority Between Creditors and the Purchaser (Buyer)

In this section we look at what will happen when a buyer buys an item that is collateral to an amount owed by the seller to a creditor. As you will see, who will win depends upon a few factors, such as whether or not the creditor is perfected, how they perfected, if the buyer has notice and if the seller is a merchant. Usually, however, a consumer who purchases the property in the ordinary course of business will prevail and get to keep the property.

Unsecured Creditor (Not Attached, Not Perfected) vs. Purchaser

The purchaser of unsecured collateral will win in competition with an unsecured creditor.

Secured, Unperfected Creditors (Attached, but Not Perfected) vs. Purchaser

Unperfected creditors will lose to bona fide purchasers who buy collateral **without notice of the security interest**.

However, purchasers will lose the purchased 'collateral' to the unperfected creditor if **they have knowledge of the security interest**.

67 c – When the collateral is moved to another state, the original security interests remain for a period of four months. Since this default took place after only two months, the perfected security interest of Larkin in the old state of residence is still valid.

Secured, Perfected Creditors (Attached and Perfected) vs. Purchaser

Perfected creditors prevail over purchasers of collateral in **most instances**. The main exception is to a consumer in the ordinary course of business (which covers a very large percentage of potential transactions).

Consumer in the Ordinary Course of Business

The most common instance of the purchaser winning is if the purchaser is a consumer in the ordinary course of business. The consumer in the **ordinary course of business** (from a merchant) **will win unless he or she knew that the items in questions should never have been sold** (for example, the consumer knew that the goods had been stolen and were not owned by the seller).

Note: A consumer (or buyer) in the ordinary course of business is someone who is a **normal customer of the seller**.

The **buyer will also win** when the **purchase is made without notice of a security interest**. When the creditor has perfected through attachment only, he will lose the collateral to a consumer who purchased the collateral, even if it is *not in the ordinary course of business*. The creditor will lose because the consumer does not have knowledge of the perfection since there was no financing statement filed.

This is relevant in the case where a PMSI creditor perfects only through the fact that he or she a PMSI creditor and does not file a financing statement.

Note: If a dispute arises between parties, a consumer or merchant who purchases the property that was collateral from a **nonmerchant** will lose the collateral to a perfected creditor. An example of this situation is when the purchaser bought the item in question from a friend.

Question 68: Under the Secured Transactions Article of the UCC, which of the following purchasers will own consumer goods free of a perfected security interest in the goods?

- a) A merchant who purchases the goods for resale.
- b) A merchant who purchases the goods for use in its business.
- c) A consumer who purchases the goods from a consumer purchaser who gave the security interest.
- d) A consumer who purchases the goods in the ordinary course of business.

(CPA Adapted, November 1994)

68 d – A consumer who purchases goods in the ordinary course of business will take the goods free of a perfected security interest in those goods.

Question 69: Ace, a refrigerator wholesaler, purchased 50 refrigerators on July 8. This comprised Ace's entire inventory and was financed under an agreement with Rome Bank that gave Rome a security interest in all refrigerators on Ace's premises, all future acquired refrigerators, and the proceeds of sales. On July 12, Rome filed a financing statement that adequately identified the collateral. On August 15, Ace sold 1 refrigerator to Cray for personal use and 4 refrigerators to Zone Co. for its business. Which of the following statements is correct?

- a) The refrigerators sold to Zone will be subject to Rome's security interest.
- b) The refrigerator sold to Cray will not be subject to Rome's security interest.
- c) The security interest does not include the proceeds from the sale of the refrigerators to Zone.
- d) The security interest may not cover after-acquired property even if the parties agree.

(CPA Adapted, November 1992)

Priorities Among Competing Creditors

In this section we look at who will win in a competition between two or more creditors who are all trying to claim the same asset.

Secured Creditor vs. Unsecured Creditors

Once a creditor **attaches** their security interest, that secured creditor has priority over the claims of all other unsecured parties. However, if the security interest fails to attach, then the creditor with the purported security interest is merely an unsecured creditor and therefore has no special rights above any other general (unsecured) creditor to the collateral property.

This means that if there is a secured creditor with a properly attached interest, that creditor will prevail against unsecured creditors.

A creditor with a **perfected security interest** has greater rights to collateral than does a creditor with an unperfected security interest. (This is the case even if the creditor has perfected through filing before the security interest has attached.)

Secured Creditors vs. Other Secured Creditors

Competing Unperfected Security Interests

If none of the competing security interests are perfected, then the one whose security interest **attaches first** has priority to the collateral.

However, if none of the interests attach, then all the creditors become unsecured and have no greater rights than any other general creditor.

69 b – Because Cray bought the refrigerator as a consumer, he will be protected against the perfected interest of Rome.

Competing Perfected Creditors

- a) **General Rule.** In the case where two or more creditors have perfected their respective security interests in a debtor's collateral, some mechanism is necessary to determine which secured creditor has the greater rights to the collateral. To resolve such conflicts among perfected creditors, the following rule applies: **the first creditor to file or perfect has priority over all other creditors.** This rule favors creditors who file, since perfection by filing may occur even before attachment occurs.

Example: Martino Music Shop enters into a loan agreement with First National Bank. First National agrees to lend Martino \$20,000, secured by Martino's store equipment. First National files a financing statement, but no funds are sent yet to Martino.

Nine days later, Martino enters into a loan agreement with Second National Bank, and Second National immediately gives Martino \$15,000, also secured by Martino's current store equipment. Second National immediately files a financing statement.

One week after Martino obtains the loan from Second National, First National sends Martino the \$20,000 according to the loan contract. If Martino defaults on both loans, which creditor has priority? Is there a PMSI creditor in this scenario?

Solution: First National Bank has priority because it filed its financing statement before Second National Bank. Thus, even though it might have believed it was protected from competing interests, Second National Bank will lose to First National Bank.

Lesson Learned: Check all financing statements on file before entering into a security agreement. If Second National Bank had followed this instruction, it would have known that a preexisting perfected security agreement was in place.

Note: Neither First National Bank nor Second National Bank are PMSI creditors.

That is the general rule. There are two very important exceptions that you need to know.

Exception 1: PMSI creditor in INVENTORY collateral.

To have priority over other perfected creditors, a PMSI creditor in inventory collateral must do two things before the debtor takes possession of the inventory collateral. The PMSI Creditor must (1) file, and (2) give written notice of his security interest to prior perfected creditors.

Exception 2: PMSI Creditor in NONinventory Collateral.

If a PMSI creditor **files a security agreement within 10 days of the date on which the debtor takes possession** of the property that is acting as the collateral, then the creditor's interest is perfected and it will be considered to have been **perfected first**. Thus, the creditor has priority over earlier perfected security interests in that property.

Note: Even though a PMSI creditor may perfect automatically on attachment, they still should file a security agreement to make their perfection even stronger.

Example: On May 1, Vito Manufacturing Company takes out a loan from First National Bank, securitized by Vito's existing and future business equipment. First National files a financing statement (including an after-acquired property clause stating that it takes an interest in business equipment that Vito will purchase in the future) on May 2.

On June 1, Vito purchases a new cash register on credit from Ace Supply Company, and Ace retains a security interest in the cash register. Ace files a financing statement on June 9.

- a) If Vito defaults on both agreements, which creditor will have priority?
- b) Would your answer change if Ace had filed on June 12?

Solution a): Even though Ace was the second creditor to perfect, Ace has priority because it is a PMSI creditor in equipment, and Ace filed within the 10-day statutory period. Note that First National is not a PMSI creditor because Vito owned the property he pledged as collateral for the First National Loan.

Solution b): If Ace had filed on June 12, its interest would be subordinate to First National Bank's interest because Ace exceeded the 10-day statutory window within which to file.

Question 70: Under the UCC Secured Transactions Article, what is the order of priority for the following security interests in store equipment?

- I. Security interest perfected by filing on April 15, 2002.
 - II. Security interest attached on April 1, 2002.
 - III. Purchase money security interest attached April 11, 2002, and perfected by filing on April 20, 2002.
- a) I, III, II.
 - b) II, I, III.
 - c) III, I, II.
 - d) III, II, I.

(CPA Adapted, May 1994)

70 c – A PMSI interest has 10 days in which to perfect. Since this perfection is done within the 10 days, this perfection is considered to be valid from the date when attachment occurred. The perfected claim from the 15th is superior to the attachment from the 1st.

Question 71: Wine purchased a computer using the proceeds of a loan from MJC Finance Company. Wine gave MJC a security interest in the computer. Wine executed a security agreement and financing statement, which was filed by MJC. Wine used the computer to monitor Wine's personal investments. Later, Wine sold the computer to Jacobs, for Jacobs' family use. Jacobs was unaware of MJC's security interest. Wine now is in default under the MJC loan. May MJC repossess the computer from Jacobs?

- a) No, because Jacobs was unaware of the MJC security interest.
- b) No, because Jacobs intended to use the computer for family or household purposes.
- c) Yes, because MJC's security interest was perfected before Jacobs' purchase.
- d) Yes, because Jacobs' purchase of the computer made Jacobs personally liable to MJC.

(CPA Adapted, May 1991)

Question 72: Non-inventory goods were purchased and delivered on June 15, 2003. Several security interests exist in these goods. Which of the following security interests has priority over the others?

- a) Security interest in future goods attached June 10, 2003.
- b) Security interest attached June 15, 2003.
- c) Security interest perfected June 20, 2003.
- d) Purchase money security interest perfected June 24, 2003.

(CPA Adapted, November 1993)

Creditor's Remedy Upon Debtor's Default

This section looks at the options that the creditor has in the case of default by the debtor.

Repossession and Auction Sale

- 1) **Peaceful Repossession.** When a debtor defaults, the creditor can repossess the collateral property, so long as there is no "breach of the peace" that results from such repossession.
- 2) **Sale or Redemption.** Once a creditor has repossessed collateral, he may sell it. However, the creditor must give proper notice of the proposed sale so that the debtor has the opportunity to redeem the collateral prior to its sale (redemption involves paying the loan in full to free the collateral from the creditor's security interest).

In a situation where the collateral is sold, the proceeds of the sale are applied in the following order to the following items:

- a. The creditor receives reimbursement for the costs of holding and selling the collateral,
- b. The creditor receives payment of the actual debt, and
- c. Any remaining money is distributed to junior security holders and then back to the debtor if there is still money remaining.

71 c – MJC may repossess because the purchase by Jacobs was not made in the ordinary course of business. Therefore, MJC interest survived this personal sale.

72 d – Because the PMSI interest was perfected within 10 days, it will be superior to all of the other claims in the question.

- 3) **Liability for Deficiency.** If the creditor sells the collateral property to a good faith purchaser (third party), that purchaser takes the property **free of liens and is not liable for any deficiency resulting from a difference between the purchase price and the amount owed by the debtor.** Instead, the debtor is liable for any deficiency (and, on the other hand, is entitled to any surplus that might result from the sale.)

Note: If there is a PMSI in **consumer goods**, and the **debtor has paid 60%** or more of the sales price, and the debtor has not renounced their rights in the property, the creditor is required to sell the asset in settlement of any outstanding debt within 90 days of repossession. If the sale is not made within 90 days, there are some amounts that are able to be recovered by the debtor.

Adjudication

The creditor also has the right to reduce his/her claim against the debtor to a judgment. That is, the creditor can sue the debtor for breach of contract. In cases where a sale of collateral is insufficient to cover the full amount of the debt, courts generally will award a **deficiency judgment** for the difference between the debt amount and the sale price of the collateral.

Question 73: Under the UCC Secured Transactions Article, which of the following statements is correct concerning the disposition of collateral by a secured creditor after a debtor's default?

- a) A good faith purchaser for value and without knowledge of any defects in the sale takes free of any subordinate liens or security interests.
- b) The debtor may not redeem the collateral after the default.
- c) Secured creditors with subordinate claims retain the right to redeem the collateral after the collateral is sold to a third party.
- d) The collateral may only be disposed of at a public sale.

(CPA Adapted, May 1993)

Question 74: Drew bought a computer for personal use from Hale Corp. for \$3,000. Drew paid \$2,000 in cash and signed a security agreement for the balance. Hale properly filed the security agreement. Drew defaulted in paying the balance of the purchase price. Hale asked Drew to pay the balance. When Drew refused, Hale peacefully repossessed the computer.

Under the UCC Secured Transactions Article, which of the following rights will Drew have?

- a) Redeem the computer after Hale sells it.
- b) Recover the sale price from Hale after Hale sells the computer.
- c) Force Hale to sell the computer.
- d) Prevent Hale from selling the computer.

(CPA Adapted, May 1994)

73 a – When the collateral is sold, the purchaser of the collateral takes the property free of any subordinate liens or security interests.

74 c – Because Drew paid more than 60% of the price, he can force Hale to sell the computer in settlement of the debt. In this case, Drew will get the excess of the sales price over the remaining amount of the debt.

Lien Creditors

When the debt is covered by a **lien** in the property of the debtor, the creditor may sell the property and take the proceeds from the sale as payment of the debt. A lien is

“an encumbrance imposed on property to force payment of a debt; if the debt remains unpaid, the property (collateral) can be sold to satisfy the debt (lien).”

In essence, a lien is another form of secured transaction in which the creditor has a claim on the property of the debtor. It is different in the way that it is formed.

There are different types of liens with which you need to be familiar. They are described as follows.

Consensual Liens

These are liens that are made with the consent of the debtor and are usually included in the original contract itself. An example is a mortgage in which the bank has the right to foreclosure upon default of the debtor. This is a **mortgage lien**.

Statutory and Common Law Liens

A statutory lien is a lien that is created by an operation of law (automatically in certain circumstances), and common law liens generally allow creditors to keep possession of the property of the debtor until the debt is paid. There are five types of statutory and common law liens that you need to know.

- 1) A **mechanic's lien** is a common law lien that gives the creditor the right to keep possession of the property of the debtor as a security against the payment for work and materials used in the repair or improvement of **real property**. If the debt is unpaid, it will be paid out of the proceeds from the next sale of the property.
- 2) An **artisan's lien** is similar to a mechanic's lien except that it relates to **personal property** and if the creditor gives up possession of the property, he or she also gives up the lien, even if the debt is unpaid.
- 3) A **bailee's lien** enables bailees to keep property that has been entrusted to them until payment is made.
- 4) In a **landlord's or innkeeper's lien**, a landlord or innkeeper can secure payment by taking a possessory lien on the tenant's property, which is located on the premises.
- 5) A **tax lien** is obtained by the government in order to secure the payment of taxes.

Note: In the above liens, the creditor must inform the debtor (give notice) before any of the assets of the debtor are sold.

One Page Summary of Secured Transactions

The first issue in secured transactions is the process of **attaching a security interest** to the assets of the debtor. There are **three requirements** that must be met before attachment may occur:

- 1) The debtor must enter into a **consensual agreement** (usually written),
- 2) The **creditor must give value** (it may be preexisting value), and
- 3) The **debtor must have rights in the property**.

When all of these conditions have been met, the creditor has a security interest in the property. However, more than one person can obtain a security interest in that same piece of property. The determination of who has rights to the property is determined through perfection.

Perfection may occur in one of three ways:

- 1) By possessing the property, or
- 2) By filing a financing statement, or
- 3) If the creditor is a PMSI creditor^b and the property is a consumer good, by attachment.

In a sense there are three levels of status of a creditor:

- 1) Unsecured (unattached),
- 2) Unperfected (secured, but not perfected), and
- 3) Perfected (secured and perfected).

The issue of attachment and perfection becomes relevant only when the debtor has defaulted on his or her payments and the creditors are trying to seize the asset in the settlement of the debt. In this case, we will look at the **various status levels of the creditors to determine who will be successful in obtaining the proceeds from the sale of the asset**.

Competitors	Winner
Buyer vs. Perfected Creditor	The buyer will win if he or she bought it from a merchant in the ordinary course of business (even if aware of the perfection) or from a nonmerchant without notice of perfection.
Buyer vs. Unperfected Creditor	The buyer will win unless he or she knew of the security interest (the attachment).
Unsecured vs. Unsecured	Whoever attached, or attaches, first will win.
Secured vs. Unsecured	The secured creditor always wins.
Perfected vs. Unperfected	Perfected wins.
Perfected vs. Perfected	The general rule is that whoever perfected first wins, however, there are two exceptions : a) A PMSI creditor in noninventory property who perfects within 10 days of the debtor taking possession of the collateral will always win. b) A PMSI creditor in inventory property will always win if they file their financing statement and notify all previously perfected creditors.

^b A PMSI creditor is a creditor who has loaned money to the debtor and the debtor has used that money to purchase the property that is acting as the collateral. This form of perfection, however, does not constitute notice. In order for notice to be given, the PMSI creditor must file a financing statement.

The following information relates to the following six questions: For each of these questions, either fill in the blank or select from a, b or c.

On January 2, 2004, Gray Interiors Corp., a retailer of sofas, contracted with Shore Furniture Co. to purchase 150 sofas for its inventory. The purchase price was \$250,000. Gray paid \$50,000 cash and gave Shore a note and security agreement for the balance. On March 1, 2004, the sofas were delivered. On March 10, 2004, Shore filed a Financing statement.

On February 1, 2004, Gray negotiated a \$1,000,000 line of credit with Float Bank, pledged its present and future inventory as security, and gave Float a security agreement. On February 20, 2004, Gray borrowed \$100,000 from the line of credit. On March 5, 2004, Float filed a financing statement.

On April 1, 2004, Dove, a consumer purchaser in the ordinary course of business, purchased a sofa from Gray. Dove was aware of both security interests.

Question 75: Shore's security interest in the sofas attached on _____.

Question 76: Float's security interest in Gray's inventory attached on _____.

Question 77: Float's security interest in Gray's inventory perfected on _____.

Question 78: Shore's security interest in the sofas was perfected on _____.

Question 79: Which of the following statements is true?

- a) Dove purchased the sofa subject to Shore's security interest.
- b) Dove purchased the sofa subject to both the Shore and Float security interests.
- c) Dove purchased the sofa free of either the Shore or float security interests.

Question 80: Which of the following statements is true?

- a) Shore's security interest has priority because it was a purchase money security interest.
- b) Float's security interest has priority because Float's financing statement was filed before Shore's.
- c) Float's security interest has priority because Float's interest attached before Shore's.

(CPA Adapted)

75 March 1, 2004 – The interest could not attach until the sofas were received.

76 February 1, 2004 – Because the interest was in present inventory, it could attach as soon as the security agreement was concluded.

77 March 5, 2004 – The security interest did not perfect until the financing statement was filed.

78 March 10, 2004 – Because it is inventory property, the perfection is done when the financing statement is filed.

79 c – Because Dove was a consumer buying in the ordinary course of business, they take the sofas free of security interests, even if they were perfected.

80 b – Because Float's financing statement was filed before Shore's it will have priority.

The following information relates to the following five questions: Under the Secured Transactions Article of the UCC, any transaction intended to establish a security interest in personal property is governed by requirements for the creation and satisfaction of that interest. For each of the items below, select from the following list the effect that will result.

- a) An attached security interest.
- b) A priority due to attachment.
- c) A priority due to perfection.
- d) A priority due to chronological order.
- e) A purchase money security interest.
- f) A security interest in receivables.
- g) A security interest perfected by filing.
- h) A security interest perfected without filing.
- i) No security interest.

Question 81: The security interest obtained by a creditor who lends money to a debtor to purchase goods used in the debtor's business will be _____.

Question 82: A seller of consumer goods who obtains an oral security agreement from a purchaser in the ordinary course of business will have _____.

Question 83: A creditor who files a financing statement would, at the most, have _____.

Question 84: A creditor who has transferred collateral to hold as security by a debtor pursuant to agreement will have _____.

Question 85: A creditor who files a financing statement on October 15 will have priority over another creditor who has a signed but unfiled security agreement dated October 1 because of _____.

(CPA Adapted)

-
- 81 e
 - 82 i
 - 83 g
 - 84 h
 - 85 c