

Secured lending law for personal property collateral in the United States

*Michael D. Floyd*¹
Professor of Law

I. The nature and purpose of secured credit

A promise to pay money is a legally enforceable obligation under the U.S.² law. However, the legal mechanism for enforcing a debt is cumbersome: typically the creditor must sue for a court judgment in order to get access to the debtor's property.³ The creditor hopes and expects that the debtor will more-or-less-cheerfully pay the obligation as agreed. That happens often, but not always.

Because of the challenges in enforcing a mere promise to pay money, especially when the debtor is resistant or disappears, or has insufficient assets, creditors are often interested in finding a secondary source of repayment. These come in various forms.⁴ The most common secondary source of repayment involves giving the creditor a special right to take certain property belonging to the debtor if the debtor doesn't pay. In the U.S., this is referred to as a "mortgage" if the property involved is real property, or a "security interest" if the property is personal property. Therefore, this paper focuses on the U.S. security interests in personal property.⁵

¹ Director of International Studies, Samford University, Cumberland School of Law, Birmingham, Alabama, USA

² In the U.S., debt obligations are generally governed by state law, so the precise rules vary from state to state. *See generally, e.g.*, Lynn M. Lopucki and Elizabeth Warren, *Secured Credit: A Systems Approach* 3-21 (7th ed 2012); David G. Epstein and Steve H. Nickles, *Debt: Bankruptcy, Article 9 and Related Laws: Modern Cases and Materials* 3-150 (1994)

³ *See id.*

⁴ *See, e.g.*, Michael D. Floyd, *Mastering Negotiable Instruments: U.C.C. Articles 3 and 4 and Other Payment Systems* 81-83 (2008).

⁵ In the U.S., "personal property" is "[a]ny movable or intangible thing that is subject to ownership and not classified as real property." *Black's Law Dictionary* 1254 (8th ed 2004).

1. The Uniform Commercial Code (U.C.C.)

The U.S. federal system is complex, in that the States are the origin of legal authority. The States delegated certain enumerated powers to the Federal government, and Federal law is supreme in those areas of Federal authority. However, the States retain the residual authority not delegated to Federal governmental power, including the so-called “police power.”

Consequently, many aspects of contract and property law remain within the authority of the States in the U.S. The laws governing interests in real property, including the real-property analogues to U.C.C. security interests, remain primarily within the State law sphere. This results in wide variations from State to State in substantive law, procedure, and terminology. This creates far fewer problems for real property, which does not move from State to State, than it does for personal property, which can and often does move.

In order to have more uniform laws among the States governing contracts and other transactions involving personal property, the Uniform Commercial Code (“U.C.C.”) was promulgated and it is the most successful efforts toward uniformity in State laws in the U.S.

Each provision of the U.C.C. (and any other uniform State law) must be enacted by each State’s legislature before becoming the law of that State. This often prevents the U.C.C. provisions from achieving complete uniformity throughout the U.S., for two reasons. First, a particular State’s legislature may not choose to enact every U.C.C. provision exactly as promulgated. Second, as State law, U.C.C. provisions are interpreted by each State’s courts, like any other state statute.⁶ Nevertheless, the U.C.C. has had enormous effect in making the law and related terminology more uniform from State to State.

2. U.C.C. Article 9 security interests

Security interests under U.S. law can be analyzed under three conceptual headings. First, has a security interest been effectively

⁶ Under the common law of the U.S. appellate decisions by both State and Federal courts have binding precedent for subsequent decisions by that court and inferior courts within that court’s jurisdiction.

created, so as to give the creditor a claim to the debtor's property? This is referred to as "attachment." Second, has the creditor's claim been noted in the appropriate public records, if required, so that others can learn of it if they are interested in the debtor's property? This is referred to as "perfection." Third, when there is more than one claim to a particular piece of property, what is the relative "priority" of each claim?

Each of those ideas is discussed below in turn.

If the debtor files a petition in bankruptcy, that can have a very significant effect on the enforcement of the security interest. However, the power to enact bankruptcy law is delegated by the States to the Federal government in the U.S., and is therefore found in the U.S. Code. Nevertheless some of the federal bankruptcy law incorporates rules from state law. Issues related to the treatment of security interests in bankruptcy are sufficiently complex and distinct to warrant analysis in a separate paper.

a. Creation of an Article 9 security interest: "attachment"

The creation of a security interest in personal property is referred to as "attachment."⁷ It reflects an agreement between the principal

⁷ U.C.C. Section 9-203 provides the rules for attachment:

- (a) A security interest attaches to collateral when it becomes enforceable against the debtor with respect to the collateral, unless an agreement expressly postpones the time of attachment.
- (b) Except as otherwise provided in subsections (c) through (i), a security interest is enforceable against the debtor and third parties with respect to the collateral only if:
 - (1) value has been given;
 - (2) the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party; and
 - (3) one of the following conditions is met:
 - (A) the debtor has authenticated a security agreement that provides a description of the collateral and, if the security interest covers timber to be cut, a description of the land concerned;
 - (B) the collateral is not a certificated security and is in the possession of the secured party under Section 9-313 pursuant to the debtor's security agreement;
 - (C) the collateral is a certificated security in registered form and the security certificate has been delivered to the secured party under Section 8-301 pursuant to the debtor's security agreement; or
 - (D) the collateral is deposit accounts, electronic chattel paper, investment property, letter-of-credit-rights, or electronic documents, and the secured party has control under Section 7-107, 9-104, 9-105, 9-106, or 9-107 pursuant to the debtor's security agreement.

U.C.C. § 9-203.

parties that the “secured party”⁸ will have special rights to the “debtor’s”⁹ property, which is called “collateral”¹⁰ and must be described in the security agreement.¹¹ The agreement between the parties is typically memorialized in writing.¹² However, there are a few specialized alternatives to a written security agreement, including possession of the collateral by the secured party.¹³

The other two formal requirements for attachment are essential, but generally are not as important as a practical matter. The secured party must give “value.”¹⁴ However, someone who has not given value rarely has an obligation to enforce via a security interest. The debtor must have “rights in the collateral or the power to transfer rights....”¹⁵ This does not require that the debtor actually own the collateral; however, under the general property maxim of *nemo dat quod non habet*, also referred to as the rule of derivative title, the secured party can get no more rights in the collateral than the debtor had.¹⁶ The secured party is classified as a “purchaser” of the collateral.

b. Public notice of an Article 9 security interest: “perfection”

Attachment of a security interest creates legally enforceable rights and obligations between the primary parties to the transaction. However, “perfection” of the security interest is usually important, in addition, in order for the secured party to have the desired full extent of protections. A security interest must have attached in order to be perfected.¹⁷

⁸ See *definition in* U.C.C. § 9-103(a)(73).

⁹ See *definition in* U.C.C. § 9-103(a)(28). Note that the U.C.C. Article 9 definition of this term focuses – counterintuitively – on the debtor’s interest in the collateral, not liability on the related debt obligation. Article 9 uses the term “obligor,” defined in U.C.C. 9-102(a)(59), for instances where the primary focus is on the debt obligation. However, in most cases, the “debtor” who grants the security interest is also the “obligor” on the related debt obligation.

¹⁰ See *definition in* U.C.C. § 9-103(a)(12).

¹¹ U.C.C. § 9-203(b)(3)(A).

¹² See U.C.C. § 9-203(b)(3)(A).

¹³ See U.C.C. § 9-203(b)(3)(B), (C), and (D).

¹⁴ U.C.C. § 9-203(b)(1). See *definition in* U.C.C. § 1-204.

The statute expresses the requirement to give value in passive voice, making it ambiguous as to whose obligation this is. In a typical credit transaction the value is given by the secured party.

¹⁵ U.C.C. § 9-203(b)(2).

¹⁶ See, e.g., Floyd, *supra* note __, at 32, 48.

¹⁷ “Except as otherwise provided in this section and Section 9-309, a security interest is perfected if it has attached and all of the applicable requirements for perfection in Section 9-310 through 9-316 have been satisfied. A security interest is perfected when it attaches if the applicable requirements are satisfied before the security interest attaches.” U.C.C. § 9-308(a).

The typical method of perfection is filing a “financing statement” with a public office, usually in a system maintained by the Secretary of State in the appropriate state.¹⁸ The financing statement must: “(1) provide[] the name of the debtor; (2) provide[] the name of the secured party; and (3) indicate[] the collateral covered by the financing statement.”¹⁹ Various additional requirements for information to be provided in financing statements is specified in the remainder of U.C.C. section 9-502(a) and sections 9-503 through 9-508. Specimen forms are provided in the statute.²⁰

Although filing a financing statement is the typical method of perfection, a number of alternatives are available. Most security interests in tangible property may be perfected by the secured party’s taking possession of the collateral. This possession may be either actual or constructive.²¹ For some types of property, possession and filing a financing statement are both effective to perfect a security interest, but taking possession of the collateral provides stronger protection to the secured party than simply filing a financing statement. Certain types of security interests are perfected automatically, upon attachment, without any additional steps for perfection being required.²² [Finally,] security interests in certain specialized types of property may be perfected only by the secured party’s taking “control” of the collateral.²³

¹⁸ “Except as otherwise provided ... a financing statement must be filed to perfect all security interests...” U.C.C. § 9-310(a). The choice of which state’s law applies is governed by U.C.C. section 9-301, and the place or places within that state where filing must occur is governed by U.C.C. section 9-501.

¹⁹ U.C.C. § 9-502(a).

²⁰ U.C.C. § 9-521.

²¹ U.C.C. § 9-____.

²² U.C.C. §§ 9-309.

²³ U.C.C. § 9-____. Control is only effective for very specific types of property. See U.C.C. § 9-____. The methods for are specified for each of these types of property. See U.C.C. §§ 9-____, 9-____, 9-____, and 9-____. taking control of property are specified in U.C.C.