

TOPIC 19: SECURED TRANSACTIONS

Overview

Security interests are a cornerstone of finance and lending. Secured lending relates directly with the amount of risk a lender faces when extending credit to a borrower. A secured transaction is one in which a lender or seller acquires an interest in the property sold or purchased with the funds provided to the borrower or debtor. The law of secured transactions regulates the relationship between the secured lender and the borrower/debtor. It also regulates the relationship (or rights) between multiple secured lenders. This chapter introduces the concept of a security interest. It begins by exploring security interests in the context of real property before moving on to personal property. It examines the rights of the secured party and the debtor in numerous situations (or transactions) involving security interests. Notably, it explains the key concept of priority among secured parties. Priority is instrumental in assessing the risk to the secured party in a given transaction.

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TOPIC 19: SECURED TRANSACTIONS - QUESTIONS & ANSWERS

1. What is a “Security Interest”?

A security interest is a form of property interest in real or personal property. It is given by the owner of the property to provide assurance to a third party that the property owner will perform an obligation or pay a debt. Generally a security interest arises when one party loans money to another party. The borrower provides a security interest in property to give assurance that she will repay the loaned funds. Often the money borrowed is used to purchase the property securing the loan. If the borrower fails to repay the loan, the lender may seek to take possession of and sell the property securing the loan. The proceeds from sale of the property are then used to repay the debt.

- *Note:* The most common types of security interest are mortgages of land and security interests in personal goods under Article 9 of the UCC.
- **Discussion:** What role do security interests play in a vibrant economy? What role do security interests play in the assessment of risk in finance?
- **Practice Question:** Arthur is considering borrowing money from Brand Bank. He is trying to evaluate whether the bank will lend him the money and at what interest rate. What is a primary consideration for the bank in determining whether to loan the money to Arthur?
- **Resource Video:** <http://thebusinessprofessor.com/security-interest-defined/>

2. What are the benefits of a security interest to creditors?

Taking a security interest in collateral to secure a debt reduces the risk to the creditor. It dissuades the creditor from defaulting on the loan for fear of losing the collateral. Also, it provides the secured creditor the ability to recuperate some or all of the debt by repossessing and selling the collateral. A security interest in property entails the secured party’s right to “repossess” and “foreclose” upon the collateral in the event of default. Foreclosure is the use of the property to satisfy the outstanding debt. There are two types of foreclosure:

- *Strict Foreclosure* - Strict foreclosure is when a secured party repossesses and retains possession of the collateral in complete satisfaction of the outstanding debt. The secured party is required to provide written notice to the debtor of this intent and, if something other than consumer goods, notice to other creditors. The debtor or any creditor may object to a strict foreclosure and force the foreclosing creditor to undertake a foreclosure sale.
 - *Note:* This is generally only an option when the foreclosing creditor is the only secured party or when all creditors agree to the foreclosure. If other creditors agree, the foreclosing creditor acquires the property clear of liens and security interests.
- *Foreclosure Sale* - A foreclosure sale is the process of selling the collateral in a private sale or at public auction. The foreclosing creditor must provide notice to the debtor and, if the goods are other than consumer goods, to other creditors. The sale must be carried out in a commercially reasonable manner.

- *Note:* A purchaser at foreclosure sale acquires the property free and clear of all inferior security interests and liens. If, however, there is a superior security interest (one with higher priority) on the property, the purchase does not take the property free and clear. This can cause serious issues for individuals who purchase the collateral at sale and are unaware of the superior security interest or lien.

A debtor generally has the right to repay the outstanding debt and reclaim the property at any time prior to the creditor foreclosing on the property. This is known as a “right of redemption”. In some jurisdiction, debtors have a statutory right of redemption for a specified period following foreclosure. This is common in foreclosures of real estate.

- **Resource Video:** <http://thebusinessprofessor.com/benefits-of-a-security-interest-in-collateral/>

SECURITY INTERESTS IN LAND

3. What are the common types of “security interest in land”?

Land or real property is an expensive asset that is often purchased through financing arrangements. As such, purchases of real property are often subject to a security interest. The most common forms of security interest in land include:

- *Mortgages*
- *Deeds of Trust*
- *Land Sales Contracts*

Each of these arrangements demonstrates the core principle of security interests. That is, there is an obligation (generally to make payments) that is secured by an interest in the real property. Each of these types of security interest is discussed in greater detail below.

- **Discussion:** Why do you think that most real estate transactions throughout the United States are made pursuant to a secured transaction? How do you think this reality affects the price of real estate and the lending habits of financial institutions? Do you understand the role of secured real estate lending had on the economic recession of 2008?

4. What is a “mortgage”?

A mortgage is a loan that is secured by real property. A borrower acquires a loan and provides a security interest in the real property owned by the borrower to be purchased with the borrowed funds. This is a common method of using “equity” or one’s ownership interest in real property to obtain funds for other purposes.

- *Note:* The real property may serve as a security interest for more than one loan. If so, this brings up the issue of priority of the security interest, which is discussed further below.

- **Discussion:** Can you find out how many homeowners in the United States own homes that are subject to a mortgage? Does this number help you to understand the role mortgages played in the economic slowdown in 2008? How do you feel about the ability to use real property to secure a loan that is unrelated to the purchase of property? What do you think about the ability of an owner of real property to have multiple loans secured by the same property?
- **Practice Question:** Veronica is considering opening a small business. She knows that she will need capital to undertake the venture, but she does not have the funds. She is considering her options. She owns a home and has a part-time job as a source of revenue. Can you identify a valid financial option for her?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-a-mortgage/>

5. How does a security interest protect the mortgage holder?

If the borrower fails to repay the loan pursuant to the terms of the loan agreement, the mortgage holder may “foreclose” upon the property securing the mortgage loan.

- **Foreclosure** - Foreclosure is the process by which the mortgage holder takes control of the property securing a debt. The mortgage is foreclosed and the property is repossessed. Once repossessed, the property is sold at public auction to generate funds to repay the loan.
 - *Note:* A party may also undertake strict foreclosure.
- **Deficiency Judgment** - If the property, once repossessed, does not generate sufficient proceeds from sale to repay the outstanding loan, there is a “deficiency”. Depending upon the mortgage foreclosure process employed by the secured lender, the property owner may still be liable for this deficiency. If so, the lender can bring a civil action asking for a “deficiency judgment” against the debtor.
 - *Note:* A deficiency judgment can be used to execute against the borrower’s other property or assets. This means that the loan holder may seek to repossess and sell the debtors other assets.
- **Right of Redemption** - Many states offer protections to borrowers who default on loans and lose their properties to foreclosure. One of these protections is known as a “right of redemption”. This right affords a borrower a specific amount of time to repay the amount owed on the foreclosed property and regain possession.
 - *Note:* This inhibits the lender’s ability to sell the land until that redemption period has passed.
 - *Example:* A lender forecloses on property securing a loan. If the state recognizes a right of redemption, a borrower, following foreclosure of his property, has the right, for a statutory period, to pay the lender the whole amount owed. This is normally done by obtaining refinancing of the property with a different lending institution.

The government (generally the local Sheriff’s office) is involved in the process of repossessing and selling the foreclosed

property. In foreclosures involving a personal residence, the process often begins with the lender seeking an eviction order against the residents of the property. Once eviction is complete, the lender may follow state procedures to list the property for sale. State law governs the sale of the property, which must be “commercially reasonable” in light of the circumstances. If the secured party pursues strict foreclosure, she may keep the collateral in complete satisfaction of the debt. In this situation, the secured lender cannot pursue a deficiency judgment against the debtor.

- **Discussion:** How do you feel about the ability of a secured lender to evict an individual from her residence? Do you think the borrower should have any additional protections in the foreclosure process? Why or why not? Why is foreclosure generally a poor option for a mortgage holder to collect the money owed from the debtor? Hint: Think in terms of time and expenses.
- **Practice Question:** Murphy owns a small tract of land. He decides to start a business and takes out a loan secured by the property to build on the land and start his business. The market is far more competitive than Murphy assumed. He is soon forced to shut down his business and defaults on the loan. What is the process the lender will follow in seeking repayment of the loaned funds?
- **Resource Video:** <http://thebusinessprofessor.com/mortgage-lender-and-benefit-of-security-interest/>

6. What is a “deed of trust” or “security deed”?

A “deed of trust”, or “security deed”, as it is known in some jurisdictions, is a form of mortgage. A borrower of money signs a promissory note demonstrating the debt owed to the lender. The promissory note will generally recite the purpose of the loan and indicate that it is secured by real property. The borrower then takes possession of the land and records her ownership. The borrower signs a deed of trust, which transfers the land to the lender. The deed cannot be recorded except upon default. This effectively grants the lender a security interest in the real property as security for the loan. The difference between a deed of trust and a standard mortgage arises in how the security interest is recorded. A traditional mortgage simply records the security interest in the public records (registrar of deeds office) where the property is located. The deed of trust takes a different tact. A third party serves as trustee and holds the deed transferring legal ownership of the land during the pendency of the mortgage. In some jurisdictions, the secured party will hold the deed, as opposed to employing the services of a third-party trustee. Once the mortgage is repaid, the trustee will surrender the deed to the purchaser. If the loan is not repaid, the lender will request that trustee turn over the deed. The lender will then record the deed in the public records to assume ownership of the property. The process of foreclosing on a deed of trust is commonly referred to as an “administrative foreclosure”. After recording the deed, the lender must then sell the property to recuperate the lent money.

- **Note:** If the sale produces more funds than those owed along with foreclosure fees, the excess funds are returned to the borrower. The notable aspect of this arrangement is that the lender may not seek a deficiency judgment if the funds from the sale of the land are insufficient to pay off the loan.
- **Discussion:** How do you feel about the traditional mortgage scenario versus a deed of trust scenario? In what way is an administrative foreclosure by way of a security deed or a deed in trust advantageous to the mortgage holder? How do the benefits to the borrower compare to the benefits to the lender?
- **Practice Question:** Kara lost her job and has fallen on difficult financial times. She has been unable to make her

mortgage payments and is afraid that her mortgage holder is going to foreclose on her home. Kara's mortgage is pursuant to a deed of trust arrangement. If the lender does foreclose, what is the legal process that Kara will face?

- **Resource Video:** <http://thebusinessprofessor.com/deeds-of-trust-and-security-deeds/>

7. What is a “land sale contract”?

A land-sale contract is a situation where the owner of land sells it subject to the condition that the seller retain title to the land until the buyer pays the full purchase price. Basically, it is a seller-financing scenario, where the seller retains ownership of the land until it is fully paid off. The rights of the buyer during this period are determined by agreement between the buyer and seller. Generally, the buyer acts as if she is the owner during the payment period. She has the legal right to possess and use the land and is responsible for paying taxes and insurance. If the purchaser fails to make any scheduled payment, she defaults under the agreement and forfeits her right to purchase the property.

- *Note:* Most states have laws protecting the purchaser in land-sale contracts. Basically, the purchaser does not forfeit her entire interest in the land in the event of a missed payment. Rather, the law recognizes an equitable interest in the land that accrues as the purchaser makes payments.

- **Discussion:** How do you feel about these types of arrangements? Can you think of situations where this arrangement could be inequitable to the purchaser? Should the law provide additional protections for the purchaser? If so, what?

- **Practice Question:** Geoffrey is considering selling his farm. Much of the farm consists of land that is suitable for hay or grazing livestock. After listing the property for several months, the only bid on the farm is from a buyer requesting the seller to finance the purchase. Geoffrey is uncomfortable with surrendering ownership of his farm until the purchase price is paid. What option might Geoffrey employ to alleviate his concerns?

- **Resource Video:** <http://thebusinessprofessor.com/land-sale-contracts-explained/>

SECURITY INTEREST IN PERSONAL PROPERTY

8. What is a security interest in personal property?

A security interest in personal property involves using any form of personal property or fixture to secure a debt. A borrower signs a promissory note that identifies the personal property that will serve as collateral to secure the loan. Personal property that may serve as collateral includes tangible and intangible assets, commercial paper, and commercial liens.

- *Tangible Assets* - Consumer goods, business equipment, farm products, and inventory.
- *Commercial Paper* - Documents of title, chattel paper, and negotiable instruments.
- *Intangible Assets* - Intellectual property, accounts receivable, and general intangibles.
- *Floating Liens:* After-acquired collateral, future advances on collateral, and proceeds from the sale of collateral.

- *Note:* Security interests in personal property are governed by the state law version of Article 9 of the Uniform Commercial Code. Article 9 does not cover security interests that are not commercial in nature.

- **Discussion:** Can you think of any business transaction that gives rise to a security interest in personal property? Hint: Think about financing situations that go beyond the traditional borrower-lender relationship.
- **Practice Question:** Curtis wants to borrow money and is concerned over what he can provide as collateral for the loan. Can you describe to him that types of personal property that can serve as collateral for a secured loan?
- **Resource Video:** <http://thebusinessprofessor.com/secured-transactions-defined/>

9. How does one establish a security interest in personal property?

A security interest in property begins when personal property is identified as collateral for a loan. This is known as “attachment” or “attaching” the property. Attachment takes place when the following conditions are met:

- *Security Agreement* - The secured party and the party granting a security interest (debtor) must enter into a written security agreement. The security agreement must be signed by the debtor and contain a reasonable description of the collateral.
- *Value Given* - The secured party must give or transfer value to the debtor. This generally means that the loaned funds are transferred to the borrower.
- *Ownership in Collateral* - The debtor must acquire ownership of the collateral. The debtor does not necessarily have to own the collateral at the time of entering into the security agreement. In some cases the debtor will use the value received from the secured party to purchase the collateral. Also, the security agreement may include an “after-acquired collateral” clause. This means that property acquired by the debtor after the loan is made can serve as collateral for the original loan.
 - *Example:* Jack loans Katy money to buy inventory to sell. Every new set of inventory replacing the sold inventory can be made subject to the security agreement.

- **Discussion:** Why do you think the law requires the above-referenced elements before a security interest attaches? Can you think of situations where any of the above elements are absent, but fairness would indicate that a security interest should attach? How do you feel about the ability of the secured party to acquire an interest in collateral that is later acquired by the debtor? Does it affect your opinion if the “after-acquired property clause” is very broad and includes all assets of the debtor?
- **Practice Question:** ABC Inc., enters into an agreement with Sasha to purchase equipment that he sells. Sasha agrees to finance the purchase but wants to establish a security interest in the equipment to make certain that ABC pays the full purchase price. What elements must be present for Sasha to establish as security interest?

- **Resource Document:** <http://thebusinessprofessor.com/attachment-of-a-security-interest/>

PERFECTION OF A SECURITY INTEREST

10. What is “perfection” of a security interest?

“Perfection” is the process of putting the entire world on notice that the secured party claims a security interest in the debtor’s collateral. Recall, a security interest is enforceable against the debtor at the time that it attaches. That is, the attached security interest will allow the secured party to repossess the assets of the debtor in the event of non-payment of the secured debt. A problem arises when other creditors of the debtor seek to establish a security interest in the debtor’s property, including the collateral already securing existing debts. These parties are effectively claiming an interest in the collateral that competes with the original secured party’s interests. Secured parties must make certain that the security interest is enforceable as against third parties who claim a competing interest in the collateral. The security interest is only enforceable as against these third parties once it is perfected. Perfection allows the secured party to maintain “priority of payment” or “priority” above other creditors in the event the collateral must be repossessed and sold to pay outstanding debts. The concept of priority of security interests is discussed further below.

- *Note:* Any party with a security interest in collateral can repossess and sell the collateral upon default by the debtor. Priority establishes a party’s entitlement to the proceeds of sale.

- **Discussion:** What do you think about the ability of multiple secured parties to claim a security interest in the same collateral? Why do you think a secured party is required to perfect (provide notice to the world) of a security interest for it to be effective as against third parties?

- **Practice Question:** Cienna sells a piece of equipment to Patrick and finances it over 12 months. She takes a security interest in the collateral to secure payment. She knows that Patrick has other loans, what should Cienna do to protect her interests?

- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-a-security-interest/>

11. What methods exist for perfecting a security interest in personal property?

Establishing or making one’s security interest effective as against third parties is known as “perfection” of the security interest. Perfection takes place when the security interest has attached and the creditor has taken all proper steps required by Article 9 for perfection. Generally, Article 9 allows a secured party to perfect her security interest through the following methods::

- **Financing Statement** - The most common way of perfecting a security interest under Article 9 is to file a financing statement in the appropriate public office. State law establishes the system and location for filing a public financing statement. Most states allow for filing through the secretary of state’s office, while other states allow for filing at a public office (such as the courthouse) in the area where the collateral is located.

- *Note:* Perfection by filing is appropriate for any collateral, except negotiable instruments.

- *Possession or Control* - In some cases, the secured party may perfect a security interest by establishing possession of or control over the collateral securing the obligation. The theory behind this method of perfection is that a third party would not reasonably extend credit and take a security interest in collateral that the debtor supposedly owns but does not possess and cannot otherwise demonstrate ownership.
 - *Note:* Control may include holding a certificate of title of physical possession of the collateral.
- *Automatic Perfection* - Some security interests are automatically perfected, either permanently or temporarily, upon attachment of the security interest to the collateral.
 - *Example: A Purchase Money Security Interest (PMSI)* is a transaction in which a lender provides funds or financing to purchase the collateral securing the loan. If the collateral is a consumer good, the lender is automatically perfected. If the collateral is a non-consumer (business) good, the security party is automatically perfected for a temporary amount of time.

Each of these methods of perfecting a security interest is discussed separately.

- **Discussion:** Why do you think the law allows secured creditors to perfect their security interests *via* multiple methods? What are the justifications for the above methods? What is the common characteristic in each of the methods of perfecting a security interest?
- **Practice Question:** Tom sells a piece of equipment to May to use in her business. He provides financing that allows May to pay for the equipment over the next 24 months. Tom and May undertook the steps necessary to attach a security interest in the equipment. What methods might Tom use to perfect his security interest?
- **Resource Video:** <http://thebusinessprofessor.com/methods-of-perfecting-a-security-interest-in-personal-property/>

12. How does a secured party establish a security interest in real property (land)?

Secured parties must perfect a security interests in land by publicly filing notice of the security in accordance with state recording statutes. Generally, mortgages and deeds of trust must be publicly registered in a government office where the land is located. This is typically known as the “recorder” or “register of deeds” office. This recording method is deemed necessary to give notice of ownership rights and interests to those who are interested in purchasing or loaning money for or against the property.

- *Note:* In addition to providing notice, registration (filing) of mortgages also establishes priority for repayment if multiple people loan or lend money secured by the property.
- **Discussion:** Why do you think securities interests in land must be filed in the government office where the land is located? Why is perfection by possession insufficient? Why do you think providing notice of security interest is particularly important for real property? Hint: Think about the nature and frequency of home purchasing *via* mortgages in the United States.

- **Practice Question:** Meredith enters into a contract to purchase real estate from Chase. Chase is going to finance the purchase for Meredith over the next 10 years. What process must Chase follow to establish his security interest in the real estate?
- **Resource Video:** <http://thebusinessprofessor.com/establishing-a-security-interest-in-real-property-land/>

AUTOMATIC PERFECTION

13. What is “automatic perfection” of a security interest?

In certain types of transactions, a secured party’s interest in collateral is automatically perfected without filing a financing statement and without taking possession or control of the collateral. This is known as “automatic perfection”. Depending upon the nature of the collateral, automatic perfection may be permanent or only last for a temporary period. Temporary automatic perfect allows a party a window of time to undertake procedures to permanently perfect the security interest. Below are the most common types of automatically perfected security interest:

- Purchase Money Security Interests in Consumer Goods,
- Purchase Money Security Interests in Non-Consumer Goods,
- Perfection in Proceeds from the Sale of Goods, and
- Assignments of Accounts Receivable and Contract Rights.

Each of these types of security interests and the automatic perfection attributes are discussed in a separate lecture.

- **Discussion:** What do you think is the justification for allowing automatic perfection of security interests in certain types of goods? Do you think it is necessary to allow for automatic perfection of security interests in the above types of goods?
- **Practice Question:** Carly finances the sale of goods to Derek. She is curious as to whether the sale is perfected or no. What information do you need to know to determine whether her security interest is perfected?
- **Resource Video:** <http://thebusinessprofessor.com/automatic-perfection-of-a-security-interest-in-goods/>

14. What is a “purchase money security interest” (PMSI) in consumer goods?

A purchase money security interest (PMSI) arises in situations where the secured party provides the funds necessary to purchase the subject collateral. This can arise through a loan for identified collateral or when the secured party sells and then finances the collateral for the purchaser. A PMSI is automatically perfected when the security agreement attaches to collateral that is consumer goods. Consumer goods are goods primarily for personal use by the purchaser — rather than for business use or resale.

- *Note:* Consumer goods do not include vehicles subject to a certificate of title or fixtures.
- *Example:* I purchase a refrigerator from Appliance World for my personal use. Appliance World finances the purchase by allowing me to pay over the next 12 months. We undertake the steps necessary for the security interest to attach. Appliance world has an automatically perfected security interest in the refrigerator.

An automatically-perfected PMSI in consumer goods is subject to certain exceptions. These exceptions allow subsequent purchasers of the collateral to take the collateral free of the secured party's security interest. The purchaser of the consumer goods from the seller will take free in clear if all of the following conditions are met:

- *No Knowledge of Security Interest* - The buyer cannot know about the security interest in the collateral;
 - *Note:* This means that the security interest is not filed in an appropriate public office, the secured party is not perfected by possession, and the purchaser has not been given notice of the security interest.
- *Provide Value* - The buyer must provide value for the goods;
 - *Note:* This means that the debtor cannot give me the goods as a gift. If I do not provide value (money or goods) in exchange for the goods, the goods are still subject to the secured party's security interests.
- *Personal Use* - Must primarily use the goods for personal, family, household purposes.
 - *Note:* So, the seller-debtor must have originally purchased the goods for personal use and the subsequent purchaser must use the goods for personal use. If either party purchases the goods for business use it will destroy the exemption.

- **Discussion:** Why do you think it is important to grant automatic perfection to individuals who sell and finance or provide purchase money for consumer goods? Also, why do you think it is important to allow purchasers who meet the above conditions to take the collateral free and clear of an automatically perfected security interest?
- **Practice Question:** Martha purchases a new vacuum cleaner from ABC Corp and finances it for 12 months. Martha signs a security agreement that grants ABC a security interest and satisfies all of the requirements of attachment. After the purchase, she does not like the vacuum cleaner and sells it to George. Will George receive the vacuum cleaner subject to ABC's security interest? What information do you need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/purchase-money-security-interest-in-consumer-goods/>

15. What is a "purchase-money grace period" for a purchase-money security interest in non-consumer goods?

Sellers of non-consumer goods receive temporary automatic perfection of an attached PMSI in the collateral sold. As the name applies, the security interest is temporary in nature. The seller has a 20-day grace period for filing a financing statement following the attachment of the purchase money security interest in the collateral. If the financing statement is filed during this 20-day period, the date of permanent perfection dates back to the date the security interest attached to the

collateral. If the secured party fails to file a financing statement during the 20-day grace period, the temporary automatic perfection is lost.

- *Note:* In that event the automatic PMSI is lost, the first secured party to perfect her security interest has priority in the collateral.

- **Discussion:** Why do you think it is important to allow a grace period for a secured party to permanently perfect her security interest in non-consumer goods? Does this create a risk to any subsequent purchaser of the goods from the original purchaser? Should such risk be balanced against the interests of the secured party? Why or why not?

- **Practice Question:** ABC Corp sells 123 Corp a piece of equipment. ABC finances the purchase over 12 months and attaches a purchase money security interest. What must ABC do to perfect its security interest?

- **Resource Video:** <http://thebusinessprofessor.com/purchase-money-grace-period-for-secured-parties/>

16. How does one continue perfection of or permanently perfect a purchase money security interest in non-consumer goods?

A secured party who takes a PMSI in non-consumer goods has a grace period to file her financing statement. To establish permanent perfection beyond the temporary grace period, she must file the appropriate financing statement within 20 days of the purchaser receiving the asset. If the secured party files the financing statement during this period, her security interest is perfected and has priority from the date of the extension of credit. Her security interest also extends to any proceeds from a later sale of the assets. This is particularly important if the goods are inventory to the purchaser. Failing to file a financing statement within this period can cause the secured party to lose priority to conflicting secured parties or lien holders who later perfect their security interests in the collateral.

- *Note:* This rule is particularly important when the debtor's assets are subject to an after-acquired collateral clause.

- **Discussion:** Do you think a secured creditor should have 20 days from the date the debtor takes possession of the collateral to file the security interest? Why or why not? Can you think of a situation where someone could be prejudiced by this right?

- **Practice Question:** ABC Corp purchases equipment from 123 Corp and finances it for 12 months. The parties validly attach the security interest to the collateral. ABC Corp immediately sells all of its assets to XYZ Corp in a buyout. What must 123 Corp do to protect its security interest in the collateral? What would this mean for XYZ Corp?

- **Resource Video:** <http://thebusinessprofessor.com/permanent-perfection-of-purchase-money-security-interest/>

17. What is “temporary automatic perfection” in “proceeds” from the sale of goods?

Proceeds is the money, assets, or value received in exchange for selling or transferring something. A perfected security

interest in collateral automatically extends to the proceeds from the sale of that collateral (with certain exceptions) for 20 days following the sale. This is a form of temporary automatic perfection. The temporary period for automatic perfection terminates at the end of the 20 days. Any of the following scenarios will extend the period of temporary perfection past the 20-day period:

- *Financing Statement & Similar Type of Collateral* - The secured party must have a filed financing statement covering the original collateral at the time it was sold. Further, the secured party must be able to perfect a security interest in the proceeds of sale of that collateral by filing a financing statement in the same government office. This means that the proceeds from sale must also be some form of goods.
 - *Note:* If the proceeds are cash (rather than more assets) then the perfected security interest may continue if the original security agreement identifies assets that could be purchased with cash proceeds and the seller indeed uses those proceeds to purchase that type of asset.
 - *Example:* ABC Corp has a security interest in equipment owned by 123 Corp. ABC files its security interest in the appropriate government office. 123 Corp later sells or trades the equipment for a newer model of equipment. ABC would file a security interest in the new equipment in the same government office. As such, the security interest filing extends to the newly acquired equipment.
- *Identifiable Proceeds* - The cash or other proceeds from the sale of the collateral must be identifiable. This means that the cash or other proceeds is not so intermingled with other funds so as to no longer be traceable to the sale of the subject collateral. This can be an issue when cash proceeds are disbursed into multiple accounts that have constantly rising and falling balances.
 - *Note:* Article 9 contains several rules for tracing proceeds and when proceeds remain identifiable.
 - *Example:* ABC Corp has a security interest in equipment owned by 123 Corp. 123 Corp later sells or trades the equipment for cash. The cash is deposited in a specific bank account and no funds are spent from that account. The funds are easily traceable and the security interest in the original collateral extends to these proceeds.
- *File New Financing Statement* - The party may perfect a new security interest in the proceeds within 20 days of the sale of the collateral. If so, the security interest continues from the date of the original security interest in the collateral.
 - *Note:* This applies when new collateral is purchased with or received as proceeds. The proceeds are not the same type as sold or there is no security interest filed before the sale.
 - *Example:* ABC Corp has a security interest in equipment owned by 123 Corp. 123 Corp later sells or trades the equipment for a different type of equipment. ABC Corp may continue its security interest by filing a new financing statement against the newly acquired equipment.

It is important to note that a debtor generally cannot sell property subject to a security interest without the permission of the secured party. Further, selling an asset to a party and failing to indicate that it is subject to a security interest may constitute fraud against the purchaser.

- **Discussion:** Why do you think it is important to grant a secured party a continued security interest in the proceeds from the sale of goods? In the same vein, what do you think is the justification for extending this security interest beyond 20 days in each of the above-indicated scenarios? Should the above protections of secured parties be balanced against the rights of the subsequent purchaser?
- **Practice Question:** ABC Corp sells equipment to 123 Corp and attaches a security interest. ABC later files the security interest in the appropriate state office. 123 Corp later sells the equipment in exchange for a combination of cash and other equipment. What are ABC Corp's options for maintaining its security interest in the proceeds of the sale?
- **Resource Video:** <http://thebusinessprofessor.com/temporary-automatic-perfection-in-proceeds-from-sale-of-goods/>

18. How is a security interest created through the “assignment of accounts receivable” and “contract rights”?

Generally, the sale or assignment of rights in accounts, payment intangibles, or promissory notes (account) creates a security interest for the individual to whom the account is assigned. This attaches the security interest to the account. Article 9 requires that an individual file a financing statement to perfect a security interest in an account. There are, however, two exceptions that allow the assignee of the account to perfect a security interest without publicly filing a financing statement.

- *Single Account to Satisfy a Debt* - The assignment of a single account in satisfaction of a preexisting debt;
 - *Example:* ABC Inc., transfers and account payable to 123 Inc., in satisfaction of a debt that ABC owed to 123. While ABC maintains control over the account payment, 123 has a security interest in the account that is perfected without filing a financing statement.
- *Automatic Perfection* - The assignor transfers a limited number of accounts to the assignee that does not constitute a significant number of the assignor's accounts.
 - *Note:* For automatic perfection to apply in this situation, the transferred account cannot constitute a significant percentage of the outstanding accounts of the transferor and the recipient cannot regularly take assignment of accounts in satisfaction of debts.

- **Discussion:** How do you feel about the ability of an assignee to perfect a security interest in an intangible account? Why do you think it is important to grant the assignee of an account receivable or contract benefits a security interest? Hint: Think about who is in control of the accounts receivable and contract rights before and after the assignment. Do you agree with the above-referenced exceptions to the requirement to file a financing statement? Why or why not?
- **Practice Question:** ABC Corp sells product at wholesale. It regularly takes payment on accounts for 90 days. These accounts sit in accounts receivable until paid. ABC Corp transfers several of these accounts to 123 Corp but maintains control over the account in order to effectuate collections. What do we need to know about this transfer

to determine whether 123 Corp has a perfected security interest in the accounts?

- **Resource Video:** <http://thebusinessprofessor.com/security-interest-in-assignment-of-accounts-receivable-or-contract-rights/>

SECURITY INTEREST BY POSSESSION or CONTROL

19. How does one perfect a security interest by “possession “of the collateral?”

Article 9 allows a secured party to perfect a security interest in goods, instruments, negotiable documents or tangible chattel paper by securing possession of the collateral. Securing possession can mean personal possession or possession by an agent. If an agent secures possession on behalf of the secured party, perfection may require the agent’s authenticated acknowledgement that the collateral is held on behalf of the secured party.

- *Note:* The debtor or an agent of the debtor cannot also serve as an agent of the secured party for purposes of perfecting a security interest.

- **Discussion:** Do you think the law should allow perfection of a security interest in certain types of collateral by simply taking possession of the collateral? Why or why not? Do you think this meets the objectives of requiring perfection of a security interest?
- **Practice Question:** Tom agrees to purchase Amy’s lawnmower. He agrees to pay for the mower by making equal payments over the next 6 months. They sign a security agreement granting Amy a security interest. Tom agrees to allow Amy to remain in possession of the lawnmower until the purchase price is paid. Is Amy’s security interest perfected?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-a-security-interest-by-possession/>

20. How does one perfect a security interest by “control” of the collateral?”

Article 9 allows for perfection of a security interest in certain types of collateral by control. These types of assets include deposit accounts, investment properties, letter-of-credit rights, and electronic chattel paper. Control is related to possession and is generally established by a control agreement granting the secured party control over the account or naming the party as owning the account. The authority that the secured party has over the collateral equates to possession.

- **Discussion:** Why do you think it is important to allow perfection of a security interest in certain types of collateral by exercising control over the collateral (in the absence of possession)?
- **Practice Question:** First Bank is a local consumer bank. Gladys is a customer of the bank and has both checking and savings accounts. She needs money, so she goes to the bank and takes out a loan. The bank requires that Gladys sign an agreement granting the bank control over the savings account, which will serve as collateral for the loan. Does the bank have a perfected security interest?

- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-a-security-interest-by-control/>

PERFECTION BY FILING

21. What information is required in a “financing statement” filing?

Generally, to perfect a security interest, a secured party may file a security agreement in the appropriate government office. To be enforceable under the UCC, a financing statement must contain the following information:

- *Debtor’s Name* - Generally this requires a first and last name. It may also require any aliases or fictitious names necessary to identify the individual;
 - *Note:* This is particularly important when the debtor is a business operating under a fictitious name.
- *Secured Party’s Name* - Name of the secured party or her representative; and
- *Identifies Collateral* - A description of the collateral must be sufficient to identify the collateral or indicate that the financing statement covers “all assets” or “all personal property” of the debtor.

Additionally, the financing statement must meet the following requirements:

- *Standard Form* - It must be in the form authorized by the filing office.
 - *Note:* UCC §9-521(a) provides an acceptable form financing statement.
- *Filing Fee* - Must include a sufficient filing fee;
- *Debtor’s Mailing Address* - This requires an address where the debtor may receive notices with regard to the filing.
- *Entity Status and Information* - Debtor’s status as an organization (type, jurisdiction, organizational ID); and
- *Secured Party’s Address* - This requires an address where the secured party may receive notices with regard to the filing.

- **Discussion:** Why do you think it is important to include all of the above information in a filed financing statement? How do you feel about the ability to include a description indicating “all assets” or “all personal property”?
- **Practice Question:** Ervin is preparing a financing statement to secure payment of property he sold to Mandy. What information must he include in the financing statement?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-of-security-interest-by-filing-financing-statement/>

22. What authorization is required to file a financing statement?

A secured party must be authorized to file a financing statement against the assets of the debtor. If the debtor is bound by a security agreement, authorization to file a financing statement is implied. If the debtor is not bound (or not yet bound) by the security agreement, the debtor must authenticate the financing statement. This is normally done by signing a confirmation document. If the financing statement is not authorized, it is ineffective and the secured party is obligated to file a termination statement (or the debtor may do so). The UCC provides for a statutory penalty of \$500 against the unauthorized filer.

- **Discussion:** Why do you think the law provides detailed instructions on when a financial statement may be filed and when a party must terminate or withdraw the filing? Should the law allow for a secured party to file a financing statement if the debtor is not yet bound by a security agreement? Why or why not?
- **Practice Question:** Mark agrees to purchase Eric's tractor. The parties have signed a promissory note, but have not yet established a written security agreement. Eric goes ahead and files a financing statement to perfect a security interest in the tractor until it is paid. What additional procedures must the parties follow?
- **Resource Video:** <http://thebusinessprofessor.com/authorization-required-to-file-financing-statement/>

23. Where is the appropriate office to file a financing statement?

Financing statements covering goods are generally filed or processed through the state secretary of state's office. Some states, however, require that the financing statement be physically filed at the local courthouse where the debtor is located. If the debtor is a business entity, the appropriate location for filing the jurisdiction where the debtor is organized. If the collateral is real estate, timber, as-extracted collateral, or fixtures, the financing statement must be filed in the local public property records. Financing statements covering goods and real estate converge when personal property becomes a fixture. In such cases, the financing statement covering goods may need to be filed in the real property records where the real estate is located.

- **Discussion:** Why do you think financing statements covering goods are filed in a central government office? Why do you think financing statements covering real estate are filed in the local office of property records?
- **Practice Question:** Sean finances the sale of a piece of equipment to Zoey. He now wants to record as security interest in the collateral. Where should Sean file the security interest?
- **Resource Video:** <http://thebusinessprofessor.com/appropriate-office-to-file-a-financing-statement/>

PRIORITY OF SECURITY INTERESTS

24. What is "priority" of a security interest?

The priority of a secured party regards the party's right to payment in the event of default by a debtor. If a debtor defaults,

a secured party with a security interest in collateral will have a claim of ownership in the collateral. As such, she can repossess the collateral, sell it, and use the proceeds to satisfy the debt. Many issues arise, however, when there are multiple creditors of the debtor. The situations gets more complicated when there are multiple secured parties claiming an interest in the subject collateral. This is when the concept of priority is most important.

- *Priority* - Priority establishes the order of who has the highest claim to assets or the proceeds from the sale of those assets. A secured party with the highest priority in collateral will receive payment of her claim before any other creditors receive payment. Subordinate secured creditors will only receive payment once the highest priority secured creditor is paid in full. Once the highest priority creditor is paid, the next highest priority creditor is paid, and so on.
 - *Note:* The secured party with the highest priority faces the lowest risk of nonpayment. The terms of secured-party lending reflects the risk associated with the borrower's priority.
- *Risk and Creditor Status* - The lower the priority of a creditor, the greater the risk that she will not receive any money from the sale of the collateral in the event of default. If a creditor's claim is not paid in full, she becomes an unsecured creditor of the debtor. Unsecured creditors generally have the highest risk of non-payment. This is particularly troublesome if the debtor files for bankruptcy protection. In the event of debtor bankruptcy, unsecured creditors generally receive a fraction, if anything, of their claim amount. Secured creditors, on the other hand, must either be paid in full or they can force the sale or surrender of the collateral securing the obligation.
 - *Note:* A debt to an unsecured creditor that is not paid in full from the debtor's bankruptcy estate is discharged. This means the debtor cannot later seek payment from the debtor and must accept the loss.

- **Discussion:** How do you feel about the priority system for establishing which creditors are paid first in the event of sale of the collateral or bankruptcy of the debtor? Is this system fair? Why or why not?
- **Practice Question:** Devon purchase equipment from Julia, who takes a security interest in the equipment. Devon has outstanding loans to Gerard and Fred. Devon defaults on all of his loans. What information do you need to determine who has priority in the collateral or proceeds from sale of the collateral?
- **Resource Video:** <http://thebusinessprofessor.com/what-is-priority-of-a-security-interest/>

25. What role does perfection play in establishing the priority of a secured party?

A secured creditor must perfect her security interest to establish the priority of her security interest with relation to all other creditors. The first secure party to perfect a security interest in the collateral generally gives her priority above any other creditors who later attempt to establish a security interest in the collateral. In turn, failing to perfect a security interest allows a later creditor who perfects her security interest in the collateral to receive priority over the unperfected security interest. Most notably, an unperfected security interest is subordinate (lower priority) to certain lien creditors or a trustee in the event of bankruptcy. In short, perfecting a security interest is essential to ensure maintenance of the benefits of the security interest.

- *Note:* There are limited situations that allow a secured creditor to receive priority over an earlier secured creditor.

This generally arises in the event of the debtor's bankruptcy. When a secured creditor is willing to extend new credit to the debtor in exchange for higher priority of her claim against the debtor.

- **Discussion:** How do you feel about the first creditor to perfect a security interest receiving priority in collateral? Is this unfair to earlier secured creditors who failed to appropriately perfect her security interest? Why or why not?
- **Practice Question:** Ester sells a piece of equipment to Sandra. At the time of the sale, Sandra has an outstanding loan to First Bank. The loan agreement with First Bank includes a security agreement covering all of Sandra's property. It also contains an after-acquired property clause. Sandra also has several unsecured loans outstanding. Ester files a financing statement covering the equipment that she sells to Sandra. Who has priority in the equipment? Do things change if Sandra files for bankruptcy?
- **Resource Video:** <http://thebusinessprofessor.com/perfection-and-priority-of-a-security-interest/>

26. What are the common types of conflicts regarding the priority of security interests?

The following types of security interest are often in conflict:

- *Lien Creditors vs. Security Interest* - A lien creditor who establishes an interest in a debtor's property prior to perfection by another secured party has priority over that secured party. Depending upon the type of lien, a lien creditor may have priority in collateral above a perfected secured party. This is true for "possessory liens" but not "non-possessory liens".
 - *Example:* Fay holds a perfected security interest in an antique piece of furniture that John owns. Don performs restoration work on John's furniture. If John does not pay for the work, Don may retain possession of the furniture pursuant to a possessory lien. This lien has priority over Fay's perfected security interest.
- *Buyers of Collateral vs. Security Interest* - Generally, buyers who take possession of the collateral in many situations take the collateral subject to a perfected security interest. Two notable exceptions arise when 1) the collateral is a consumer good for personal use being sold to another consumer for personal use, and 2) when the collateral is inventory for the debtor. In either situation, a buyer of collateral subject to a security interest generally takes the collateral free of a security interest if the collateral is inventory for the seller or the security interest has not been perfected.
 - *Note:* A purchaser of goods subject to an unperfected security interest takes the goods free of the security interest only if the purchaser is unaware of the existence of the security interest.
 - *Example:* Hazel owns a small store. Gail holds a security interest in all of Hazel's assets, which consists of some equipment and lots of inventory. Ira purchases goods from Hazel. She takes these goods free of Gail's security interest because the goods are inventory for Hazel's business. Juliet later purchases a piece of equipment from Hazel that is not part of her inventory. If she is unaware of the existence of the security interest at the time of her purchase, she takes the equipment free of Gail's security interest.

- *Note:* Gail likely has a security interest in the proceeds from the sale of Hazel's inventory.
- *Perfected vs Unperfected* - A perfected security interest in collateral has priority over an unperfected security interest in the same collateral. This is true regardless of the timing of attachment of the security interest.
 - *Example:* Kyle takes a security interest in Leo's property on October 1. He never perfects his security interest. On December 1, Marty takes a security interest in Leo's property and perfects his interest by filing in a public office. Marty's security interest has priority over Kyle's security interest.

Each of these scenarios are discussed in greater detail below.

- **Discussion:** Why do you think the priority of the above types of secured creditor often comes into conflict? Do you generally agree with the order of priority? Why or why not? Do you notice any common principles reflected in the established order of priority?
- **Practice Question:** Beverly purchases a piece of equipment from Eve. Eve establishes an attached security interest in the collateral. Carlos later purchases the equipment from Eve. What additional information about this situation do you need to determine whether Carlos' equipment is subject to Eve's security interests?
- **Resource Video:** <http://thebusinessprofessor.com/priority-regarding-conflicts-in-security-interests/>

27. What is the priority of parties secured by “common law and statutory liens”?

Possessory Liens - A possessory lien is a common law or statutory interest in an asset that:

- secures a payment for services or material furnished in the ordinary course of business;
- is create pursuant to statute or common law; and
- the asset is under the control of the lien holder.

A possessory lien, as the name implies, gives priority in situations where an individual has physical possession of the collateral.

- *Example:* Common types of possessory lien include: repair and storage, boarding of animals, and labor performed or material supplied in course of performance.

Non-Possessory Lien - A non-possessory lien generally arises through judicial or administrative order.

- *Example:* A common form of non-possessory lien is a judgment that is attached to a debtor's property.

A possessory lien has priority over an Article 9 security interest, unless the common law or statutory authority for creating the lien indicates otherwise. A non-possessory lien, on the other hand, does not have priority over a security interest that is

perfected prior to the establishment of the lien. It does, however, have priority over an unperfected security interest.

- **Discussion:** Why do you think the law allows a possessory lien to claim priority over a perfected security interest? Should a non-possessory lien be given priority over a perfected security interest? Why or why not? Should a non-possessory lien be given priority over an unperfected security interest? Why or why not? Can you identify a common objective among these priority rules?
- **Practice Question:** Nate holds a perfected security interest on Mandy’s lawn mower. She takes the mower to Olivia’s shop for repairs. While the mower is being repaired, she is held liable to Patrick in court. The court issues a judgment in favor of Patrick that he seeks to execute by attaching it to Mandy’s mower. Who’s security interest likely has priority in this situation?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-parties-holding-statutory-and-common-law-liens/>

28. What is the “priority of buyers of collateral” that is subject to a security interest?

Generally, a buyer of collateral subject to a security interest takes the property subject to that security interest. That is, if a debtor sells collateral that is subject to a security interest, the security interest continues in the collateral following the sale to the buyer. This is true for validly perfected security interests or if the buyer knows about the security interest at the time of purchase. If the security interest remains with the collateral, this means that the secured party can repossess the subject collateral in the event of default on the original loan or obligation.

- **Note:** Repossessing goods from the purchaser of collateral subject to a security interest may require bringing a conversion action against the debtor in possession of the collateral.

The following exceptions apply to this rule:

- **Authorization of Secured Party** - A primary exception to this rule is when the secured party authorizes the sale. A secured party’s failure to object to the sale of the collateral may constitute authorization. Also, allowing prior sales of collateral without objecting may constitute an implied agreement authorizing the debtor to sell the collateral.
- **Buyers in the Ordinary Course of Business** - A “buyer in the ordinary course of business” (BOCB) takes collateral free of any security interests created by the seller. This is true whether the security interest is perfected or no.
- **Consumers Purchasing Consumer Goods from Other Consumers** - A purchaser of consumer goods from another consumer may take the goods free of an existing security interest. Two provisions protect consumers in this situation, UCC § 9-320(b) and the “Shelter Principle”.

Each of the above rules protecting purchasers of collateral subject to a security interest is explained below.

- **Discussion:** How do you feel about the principle that a purchaser of collateral subject to a security interest takes the goods subject to the security interest? Do you think the above-referenced exceptions to this rule are necessary? Why or why not? Are they adequate?

- **Practice Question:** Mark purchases a piece of equipment from Iris. Mark has become concerned that the equipment was subject to a security interest when Iris sold it to him. What information will you need to know to determine whether Mark's equipment is still subject to the security interest?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-a-secured-party-vs-a-buyer-of-collateral/>

29. What is required to be a buyer in the “ordinary course of business”?

A buyer in the ordinary course of business must meet the following characteristics:

- *Good Faith* - The purchaser of the collateral must buy it in good faith and without the intent to defraud or deceive;
- *Not Aware of Violation of Rights* - The buyer cannot know that the sale of the collateral violates the security interest of a third party. She can know about the security interest but cannot be aware that the sale of the collateral is not authorized; and
- *Ordinary Course of Business* - The buyer must purchase the goods under normal purchasing conditions from a seller of goods of that kind. Basically, the collateral purchased must be inventory that is regularly sold by the seller.
 - *Example:* Buying a used piece of operational equipment from a business that does not regularly sell that type of equipment would not qualify.

The buyer-in-ordinary course exception only applies to security interests that were validly entered into by the seller of the goods of this kind. It does not protect anyone who later purchases the collateral from the BOCB. This harsh result is addressed *via* UCC § 9-320(b) and the Shelter Principle.

- *Note:* The UCC intentionally excludes pawnbrokers from buyers in the ordinary course. It also excludes bulk transfers of goods or the transfer of goods as a security interest or in satisfaction of an existing debt.

- **Discussion:** What do you think about the buyer in the ordinary course exception? What objective is served by this rule? Is the rule too broad or overly narrow in its protections of purchasers? Why?
- **Practice Question:** Rosa purchases and finances her inventory from Sam. Sam takes a security in Rosa's inventory. Tom purchases a good from Rosa. Does Tom take the goods subject to Sam's security interest? What facts do we need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/protections-of-a-buyer-in-the-ordinary-course-of-business/>

30. What statutory provision protects individuals purchasing goods from a buyer in the ordinary course?

The buyer-in-the-ordinary course protection does not apply to subsequent purchases from a buyer in the ordinary course because the seller is not a seller of goods of the kind. So, if a BYOC subsequently sells the collateral purchased, the

purchaser will take the goods subject to the original secured party's security interest. This is a harsh result for the unsuspecting purchaser. UCC § 9-320(b) may remedy this harsh result by offering protections to the buyer if the security interest is not perfected. Under § 9-320(b) the buyer takes the collateral free of the security interest under the following conditions:

- *Consumer Goods* - The goods are consumer goods in the hands of the seller;
 - *Note*: The buyer in the ordinary course cannot be a business.
- *No Knowledge of Security Interest* - The buyer buys without knowledge of the security interest;
- *Provide Value for Goods* - The buyer buys the collateral for value (generally cash);
 - *Note*: The recipient of a gift is not protected.
- *Personal Use* - The buyer buys the collateral for his own personal, family, or household purposes; and
- *No Financing Statement* - The secured party has not filed a financing statement covering the goods prior to the purchase.

This is a very limited protection when the secured party does not perfect or relies on automatic perfection of a security interest in the sale of consumer goods. Further, the buyer and in the ordinary course and the subsequent buyer must be consumers.

- **Discussion**: What do you think about this extension of protections to purchasers who do not qualify as buyers in the ordinary course? Is this protection adequate or is it too narrow in its protections? Why?
- **Practice Question**: Venus has a lawnmower that she purchased from ABC Corp. Venus financed the purchase through ABC Corp. She later offers to sell her lawn mower to Wyatt. Wyatt agrees to purchase the mower. What information do we need to know to determine whether Wyatt takes the lawn mower subject to ABC's security interest?
- **Resource Video**: <http://thebusinessprofessor.com/security-interests-in-goods-purchase-from-one-consumer-by-another/>

31. What is the “Shelter Principle” - Section 2-403(1)?

The shelter principle offers additional protections for buyers of collateral from other consumers. Basically, this equitable principle states that a good faith purchaser of property acquires all of the rights that the transferor of that property. The shelter rule will provide the purchaser with a claim of interests that may be superior to a previously perfected secured creditor. The shelter principle is broader than the BYOC and UCC 9-320 protections. It protects consumer and non-consumers who purchase collateral from a buyer in the ordinary course. Further, it protects the buyer in situations where the secured party has filed a security interest covering the collateral, which is outside of the scope of 9-320.

- *Example:* Suppose Biz, LLC purchases a good used personally by a consumer, Tom. The good was subject to a perfected security interest as inventory in the hands of the seller, Seller, Inc., when it was originally sold to Tom. Tom, as a consumer, would have taken the item free and clear of the security interest in the inventory. When Tom later sells the item to Biz, LLC, the shelter principle is the only rule to protect it. Biz, LLC does not qualify as a purchaser in the ordinary course and is not protected as a consumer under UCC 9-320. Biz, LLC, as a subsequent purchaser or transferee of that collateral from the buyer, receives all of Tom's rights in the collateral. As such, Biz, LLC takes the collateral free and clear of the original security interest. It does not matter whether Seller, Inc., filed a financing statement to perfect the security interest.

- **Discussion:** How do you feel about the Shelter Principle? What do you think are the objectives behind the Shelter Principle? Is the rule adequate or overly broad? Why? Do the protections for business and consumers against filed and unfiled security interests affect your opinion?
- **Practice Question:** Yolanda purchases a couch from ABC Inc. ABC perfects a security interest in the couch. Yolanda later sells the couch to Zora. Is Zora's couch still subject to ABC's security interest? What information do we need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/the-shelter-principle-and-buyers-of-collateral/>

PRIORITY OF PERFECTED & UNPERFECTED SECURITY INTERESTS

32. What are the general “priority rules” for security interests?

The following are the general priority rules for security interests:

- *Perfected vs Unperfected Security Interests* - A perfected security interest has priority over an unperfected security interest. This is true even if the unperfected security interest was established well before the perfected security interest.
 - *Note:* This fact can give rise to issues when a party's security interest has temporary automatic perfection.
- *Unperfected vs Unperfected Security Interests* - Unperfected security interests have priority based upon the order of attachment of the security interest. In this case, the earlier party to establish the security interest has priority over those coming later.
 - *Note:* A later unsecured party may establish priority by filing her security interest (or otherwise perfecting) before the other secured parties.
- *Multiple Perfected Security Interests* - The first secured party to file or perfect is entitled to priority over secured parties later acquiring or perfecting their interest in the subject collateral. This situation also brings up an issue for temporary automatic perfection. If a party takes the steps necessary to continue the temporary automatic perfection, her perfection date is retroactive back to the date and time that the security interest attached. This becomes an issue when the collateral is also subject to an “after-acquired collateral” clause. If she fails to take the steps necessary to continue the security interest, any third party may establish a security interest in the

collateral and gain priority over her unperfected security interest.

- *Note:* An issue arises for collateral that is used to secure “future advances”.

These are default rules. Any of these rules can be changed pursuant to agreement between the parties. That is, a party can agree to subordinate her security interest to the security interests of others. This is important when new lenders require priority of a security interest before extending new credit to a debtor.

- **Discussion:** How do you feel about the above-stated priority rules applicable to security interests? Is it fair that a party can establish priority over an earlier security interest by being the first to file? Why or why not? Can you think of any situations where the automatic temporary perfection rules could cause an issue?
- **Practice Question:** Heidi purchases a piece of equipment from Indira. Indira finances the purchase and attaches a security interest. Heidi has a loan outstanding to Jan that has an after-acquired property clause in the security agreement. After the purchase of the equipment, Heidi borrows money from Kyle, who takes a security interest in all of Heidi’s assets. If Heidi defaults on all of her debts, who has priority of payment from the sale of the equipment? What other information do we need to know to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/priority-rules-for-conflicting-security-interests/>

33. Who has “priority in proceeds” from the sale of collateral?

A secured party who perfects her security interest in collateral may have a continued security interest in the proceeds from the sale of that collateral. Thus, a secured party with priority in collateral will also maintain priority in the proceeds from sale of that collateral. In this case, the date of perfection of the security interest in the proceeds is the same as the perfection date for a security interest in the collateral. The priority of secured parties following the sale of collateral is generally as follows:

- **Cash or Similar Property Proceeds** - A secured party has priority over a conflicting security interest in proceeds if she has perfected her security interest and the proceeds of sale are cash or of the same type as the collateral.
 - *Example:* Mark and Jay have security interests in Tom’s asset. Mark’s security interest has priority over Jays. If Tom sells the asset and receive cash or another similar asset, Mark and Jay maintain a security interest in the cash or similar equipment. Mark’s security interest retains priority.
- **Non-Filing Collateral** - Special rules apply to a security interest in collateral that can only be perfected in a manner other than filing (control or possession). Common types of collateral perfected by possession include chattel paper, deposit accounts, negotiable documents, instruments, investment property, and letter of credit. Priority of security interests in the proceeds from the sale of non-filing collateral ranks according to the time of filing of a security interest in that collateral. This rule provides priority to the first secured party to file a security interest in the newly acquired proceeds. Secured parties that have already filed a security interest on “all equipment” of the debtor at the time of sale of the non-filing collateral generally have priority.
 - *Example:* Leo has numerous creditors who have security interests in all of his assets. He owns and has

possession over some chattel paper. When he sells the chattel paper and acquires equipment, his creditors have priority in the equipment based upon the timing of filing of a security interest.

- **Discussion:** Do you agree with the premise that a secured party should have priority in proceeds from the sale of the collateral? Why do you think special rules exist for non-filing collateral? Do you agree with the first-to-file rule applicable to non-filing collateral? Why or why not?
- **Practice Question:** Merrill has a security interest in “all assets” of Nancy. Oscar also has a security interest in “all assets” of Nancy, but it was filed at a later time. Oscar’s security agreement contains a provision providing for a security interest in “after-acquired collateral”. Nancy later sells some negotiable instruments and receive some cash and a painting. Merrill immediately files a financing statement covering the painting. Who has priority in the proceeds and why?
- **Resource Video:** <http://thebusinessprofessor.com/special-priority-rules-for-proceeds-from-sale-of-collateral/>

34. What is a secured party’s priority in “future advances” of funds to the debtor?

Future advances of funds are funds provided to a debtor based upon an existing lending agreement. This is common when a debtor establishes a line of credit with a lender. The lender will advance funds to the debtor when requested. Generally, a security agreement will provide that the lender is secured by any collateral securing a future advance or new collateral acquired with the advanced funds. The rules for priority in future advances are as follows:

- **Time of Perfection** - Generally, the time of perfection of a security interest establishes priority with respect to future advances. That is, if a lender makes an advance of funds based upon a prior agreement, the priority of the lender’s security interest in collateral securing the advance is determined by the time of the filing of the financing statement covering the collateral. If the debtor has secured creditors with priority above that of the lender, these creditors retain priority in the collateral despite the future advance.
 - **Example:** First Bank lends money to Mark and takes a security interest in Mark’s lawn mower. Mark later borrows money from Second Bank that takes a security interest in all of Mark’s assets. As such, First Bank’s security interest in the lawn mower has priority over that of Second Bank. If First Bank makes a future advance to Mark pursuant to the original lending agreement, First Bank will have priority based upon its original security agreement and financing statement. If, however, First Bank’s security agreement does not cover future advances, Second Bank’s security interest in the collateral will have priority over a subsequent security interest filed by First Bank against the collateral to secure payment of the future advance.
- **Priority over Lien Creditors** - A secured party that advances additional funds and claims a security interest against the original collateral has priority over a lien creditors of the debtor if:
 - The secured party made the advance of new credit within 45 days after the lien attaches, or
 - The secured party made the advance of funds more than 45 days after the lien attaches, but without knowledge of the lien or pursuant to a prior agreement entered into without knowledge of

the lien.

- *Example:* First Bank lends money to Katherine and takes a security interest in Katherine's jewelry. A creditor receives a judgment against Katherine and establishes a lien against her jewelry. First Bank later makes a future advance to Katherine that is secured by her jewelry. If First Bank made the advance within 45 days of the lien creditor establishing its lien, then First Bank will have priority. If First Bank makes the future advance more than 45 days after the lien is established, it will have priority if the future advance was pursuant to the original lending agreement providing for a security interest in the collateral or if First Bank had no knowledge of the other creditor's lien at the time of the advance.
- *Priority over Buyers of Collateral* - A secured party who makes future advances against collateral has priority over a buyer of the collateral in the ordinary course if:
 - The secured party's advance is made within 45 days and without knowledge of the purchase; or
 - The advance was made pursuant to a commitment established within 45 days of and without knowledge of the purchase.
- *Note:* This provision keeps a debtor from selling collateral and then seeking a future advance secured by the collateral.
- *Example:* First Bank has a security interest in ABC's inventory. ABC sells an item of inventory to Fanny. Fanny takes the item subject to First Bank's security interest in the inventory if the advance was made within 45 days of the sale or the advance was made pursuant to a security agreement entered into within 45 days and without knowledge of the sale to Fanny.

- **Discussion:** How do you feel about the rules providing for priority for future advances? Do you agree that with the priority rules for future advances above that of lien creditors? Why or why not? Do you agree that with the priority rules for future advances above that of buyers of the collateral in the ordinary course? Why or why not? Can you think of situations where this rule would unduly prejudice lien creditors or buyers in the ordinary course?
- **Practice Question:** Luther borrows funds from First Bank. First bank establishes a security agreement and perfects a security interest in Luther's tractors. Luther later takes out loans from Second Bank and Third Bank. Both banks establish security agreements in all of Luther's assets. Luther also becomes subject to a lien creditor. Troubled with money issues, Luther sells the tractor without notifying his creditors. Soon thereafter, First Bank makes a future advance to Luther secured by the tractor. Which creditor's security interest, if any, has priority in the collateral? What additional information do we need to answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/secured-party-priority-in-future-advances-to-debtor/>

PRIORITY OF PURCHASE MONEY SECURITY INTERESTS

35. What is the priority of a purchase-money security interest in goods (other than inventory and livestock)?

A purchase-money security interest (PMSI) is a security interest in collateral purchased with the value extended by the creditor. A seller or lender may also acquire a PMSI in goods sold if it finances the purchase. A perfected purchase-money security interest in goods (other than inventory or livestock) has priority over conflicting security interests if the security interest is perfected within 20 days of the debtor receiving possession of the goods. Also, the PMSI provides for priority in identifiable proceeds of the collateral if sold. There is, however, a potential conflict in this situation with secured parties perfected by control over deposit accounts. If the PMSI collateral is sold and the proceeds deposited in a controlled deposit account, a party with a security interest in the deposit account would have priority to the funds.

- *Note:* A secured party does not lose PMSI protection because the underlying obligation is renewed, refinanced, or restructured.

- **Discussion:** How do you feel about a purchase-money lender's ability to establish priority for its security interest in goods acquired with the value extended to the debtor? Should the purchase-money lender's security interest lose priority if not filed within the 20-day period? Why or why not? Can you think of any conflicts between lenders that could arise because of the 20-day filing window for continued perfection?

- **Practice Question:** ABC Corp sells printer equipment. 123, LLC purchases a new office printer. ABC finances the purchase over 12 months and attaches a security interest. What will ABC Corp need to do to perfect or continue perfection of its security interest?

- **Resource Video:** <http://thebusinessprofessor.com/priority-of-purchase-money-security-interest-in-collateral/>

36. What is the priority of a purchase-money security interest in inventory?

Special rules apply to purchase money security interests in inventory. In order to qualify for PMSI priority in inventory, the secured transaction must meet the following requirements:

- *Perfection at Time of Possession* - The PMSI must have been perfected at the time the debtor takes possession of the inventory. This means the security agreement and value extended must have taken place prior to the receipt of the inventory.
 - *Note:* This can be temporary automatic perfection that is later extended by filing within the 20-day window. The key aspect is that the security agreement must have already attached.
- *Notice to Secured Parties* - The secured party must provide authenticated notification to any holders of conflicting security interests in the debtor's collateral prior to perfection. The holder of the conflicting security interest must receive the notice within 5 years prior to the debtor obtaining possession of the collateral.
 - *Note:* Lenders who finance the purchase of inventory often send blanket notices to secured creditors that they will be extending credit and perfect a security interest.
- *Description of PMSI Collateral* - The notification to other secured parties must state that the creditor intends to take a PMSI in the debtor's inventory and it must describe the inventory.

The UCC extends PMSI priority to identifiable proceeds from the sale of the collateral. The priority in cash is limited, however, if the cash is deposited in a deposit account.

- **Discussion:** Why do you think the law requires additional notification procedures to claim a PMSI in inventory? Why do you think the law requires perfection at the time the debtor takes possession? Does this right detriment existing secured creditors? Why or why not?
- **Practice Question:** ABC Corp is a lender that regularly finances inventory purchase for small businesses. ABC loans money to 123, LLC to purchase inventory. LLC has numerous creditors with perfected security interests in all of 123's assets. What process must ABC follow if it intends to lend money to 123 to purchase inventory and wishes to perfect a purchase money security interest?
- **Resource Video:** <http://thebusinessprofessor.com/purchase-money-security-interest-in-inventory/>

37. What is the priority of conflicting purchase-money security interests?

Often a debtor will acquire property subject to multiple purchase-money security interests. This happens when multiple parties lend money for the purchase (enabling loans) and the seller of the good finances part of the purchase. In such a situation, the UCC provides priority for the individual financing the purchase over individuals providing a financing loan. If all of the financiers or enabling lenders are the same, the UCC provides that the first to file or perfect the security interest determines priority.

- **Discussion:** Why do you think the law prefers financing sellers over enabling lenders? If all lenders have similar PMSIs, how do you feel about the first to file system?
- **Practice Question:** ABC Corp purchase equipment from 123, LLC. ABC places a down payment of 50% of the value and finances the remaining 50% through 123. 333, Inc., and 444, Inc., make separate loans in equal amounts to ABC to provide the money to place the 50% down payment. In this situation, what is the priority of security interests?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-purchase-money-security-interest/>

FIXTURES AND SECURITY INTERESTS

38. What is the priority of security interests in fixtures?

A fixture is a piece of personal property that is installed on and made one with real estate. The primary characteristic of a fixture is that it is not readily moveable. It has assumed a state of semi-permanence on the real estate. The downside to this situation is that it causes issues regarding the priority of security interests in the real estate and in the fixture. Under the UCC, a secured party with a security interest in a personal good that will become a fixture must make a fixture filing in the appropriate government office to establish the priority of her security interest in the fixture. If the secured party fails to make a fixture filing, a security interest in the fixture is subordinate to a conflicting interest of the owner of real property or party holding a security interest in the real property.

- **Discussion:** How do you feel about the requirement to affirmatively claim priority of a fixture? Why do you think the law places the burden upon the owner of the fixture to maintain a security interest rather than the owner of the real estate to establish a claim in the fixture?
- **Practice Question:** Alvin has a security interest in a piece of equipment he sold to Beatty. Beatty permanently installs the equipment on his real estate that is subject to a mortgage owed to First Bank. Whose security interest has priority in the equipment? What information do you need to know to accurately answer this question?
- **Resource Video:** <http://thebusinessprofessor.com/priority-of-security-interest-in-fixtures/>

39. What is the scope of fixture priority rules?

The following rules govern the priority as between secured parties with security interests in fixtures and persons who claim an interest in real property to which the fixture attaches.

Purchase-Money Priority in Fixtures - The UCC provides for priority for purchase money security interest in fixtures. To establish priority over conflicting security interests in the real estate, the following conditions must be met:

- *Recorded Interest in Real Estate* - The debtor has a record interest in or possession of the real estate;
- *PMSI in Fixture* - The secured party holds a purchase-money security interest in the fixture;
- *Prior Ownership of Real Property* - The interest of the mortgage holder of the real property arose before the goods became fixtures; and
- *Prior Fixture Filing* - The security interest is perfected by a fixture filing before the goods became fixtures or within 20 days thereafter.

The twenty-day grace period can cause issues for the secured party holding a PMSI in the equipment. If a third-party perfects a security interest in the real estate after the fixture is installed but before the PMSI secured party can make a fixture filing, the third-party has priority in the fixture. The way to maintain priority is either file before the fixture is installed or the PMSI holder files before any third parties file an interest in the real estate.

- *Note:* A security interest in a fixture (whether perfected or no) has priority over a conflicting security interest in real property if the owner of the real property has consented to the security interest or disclaimed an interest in the goods as fixtures in an authenticated record.

- **Discussion:** How do you feel about the requirement for a party with a PMSI in a good to file a financing statement within 20 days of the good becoming a fixture? Does this run counter to the objectives of providing priority to a PMSI over other security interests?
- **Practice Question:** ABC Corp loans money to 123, LLC to purchase equipment for its business operations. ABC Corp attaches a security interest in the equipment and files a financing statement. 123 intends to install the

equipment on its real estate that is subject to a mortgage held by First Bank. ABC initially forbids 123 from permanently installing the equipment, but they withdraw their objection when First Bank acknowledges ABC's rights in the equipment in an email. 123 later falls on hard times and defaults on all of its obligations. What is the priority of security interests in the fixture? What do you need to know about this situation to accurately answer this question?

- **Resource Video:** <http://thebusinessprofessor.com/priority-of-fixture-filer-vs-mortgage-holder/>