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INTRODUCTION

In the movie *Wall Street*, the neophyte stockbroker is concerned that what Gordon Gekko proposes is insider trading. Gekko responds, "Either you're *inside,* or you're *outside.*" That is the way it is with credit. Either you're *secured* or you're *unsecured.*

You may already have some sense of the difference. We usually describe secured loans by reference to the collateral. We talk about home loans, car loans, inventory loans, and farm crop loans, to mention just a few. Among the credit extensions usually made on an unsecured basis are credit cards, bonds issued to investors by large companies, student loans, loans between friends, trade credit (a business's purchase of inventory on credit), and many loans by commercial banks and insurance companies.

Secured status comes in essentially two forms: security interests created by contracts and liens created by statutes or judicial acts. Each security interest or lien is a relationship between a debt and property that serves as collateral. The debt can be almost any kind of contractual promise or legal obligation. Collateral can be nearly anything of value, real or personal, tangible or intangible. The security interest or lien is the right, in the event that the debt is not paid when due, to force a sale of the collateral and have the proceeds applied to pay the debt.

Secured creditors have "priority" over unsecured creditors. Priority is the right to be paid from the value of the collateral, up to the full amount of the debt, in preference to any competing interest.

Secured status is essential to the debt collection process. But security is of even greater importance than that statement suggests. Security can be used to prioritize any legal right that carries a damage remedy. That is, unilaterally granting a security interest to the holder of one right gives that holder priority over the holders of all other rights. As a result, security interests and liens are fundamental to all deal making, from divorce settlements to mergers. By determining whose legal rights have priority, security determines who has power. That effect is present even if the obligation is never in default. Anyone who has taken out a mortgage on a home or signed a security agreement to buy a car will know what we mean.

Most secured creditors obtain their rights by contract. Those private contracts—*security agreements*—bind the parties who sign them. In addition to establishing the legal rights of the debtor and creditor, the security agreement is effect against the world. For example, Uniform Commercial Code §9-201 provides that "Except as otherwise provided in the Uniform Commercial Code, a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors." Security is an agreement between A and B that C take nothing.

The idea of a private contract that binds non-parties is, for most of us, startling. Defenders analogize security agreements to real estate conveyances. They argue that, by granting a security interest, the debtor conditionally sells the collateral to the extent of the secured obligation. (Quite a mouthful, isn't it?) They also note that the Uniform Commercial Code requires the parties, in most instances, to provide public notice of the agreement's existence by making a UCC filing. (What? You've never heard of the UCC filing system? Your legal rights have been affected by this system since before you were born. When you make certain purchases, you are charged with the knowledge that the system would have provided—if only you had known to look.)

Part One of this book deals with the relationship between the debtor and the secured creditor. In Assignment 1, we explain the remedies available to unpaid unsecured creditors. That provides a baseline from which to understand the additional remedies available only to secured creditors. In Assignments 2 through 5, we explain the remedies available to secured creditors against their non-bankrupt debtors. In Assignments 6 and 7, we explain how filing bankruptcy immediately interrupts, and ultimately alters, the creditors' remedies.

In Assignment 8, we describe how easy it is for debtors to create security interests in their property. Provided that the creditor gives consideration sufficient to support a simple contract, its debtor need only authenticate a record (UCC terminology for signing a contract) containing a one-sentence grant to render that creditor secured. In Assignments 9 through 12, we explain the reach of the security interest thus created: what collateral it covers and what debts it secures. Assignments 13 and 14 deal with the secured creditor's right to "accelerate" payments of installment debt, such as home mortgages or car loans, when the debtor is in default. Part One concludes with Assignment 15, which describes a prototype secured transaction and provides the opportunity to bring together what has been learned to this point.

Part Two of this book deals with competitions between secured creditors and a variety of third parties who may claim the collateral. For their priority in the collateral to be effective against other competitors, the law requires that most kinds of secured creditors "perfect" their security interests by giving public notice. Assignments 16 through 21 explain how secured creditors give that notice—principally through filings in public records systems, which their competitors are expected to search. In Assignments 22 through 25, we explain what the holder of a perfected security interest must do to maintain that perfection as circumstances change.

Assignments 26 and 27 explain what it means to have priority—first under state law and then in bankruptcy. Assignments 28 through 39 deal with the issue of who has priority over whom. In these assignments we discuss the various kinds of competitors for collateral, one competitor at a time. Those competitors include other secured creditors, the holders of judicially created liens, bankruptcy trustees, persons who sold the collateral to the debtor, persons who bought the collateral from the debtor, federal tax liens, and other kinds of statutory liens. Assignment 40 brings together all the themes developed to evaluate the secured credit system.

We have written this book with an attitude. Legal education has a way of taking simple things and making them seem complex. In this book we have made every effort to do the opposite—to make this complex, technical subject as simple as possible. This is a course for second- and third-year students who have already mastered reading cases. The threshold intellectual task here is to read statutes; the ultimate intellectual task is to see how law functions together with other elements as a law-related system. Someone who masters that task can see law with new eyes—can see better whom law helps, whom it hurts, what implications it has for planning and transactional work, and how it can be manipulated, for better or for worse, to produce unexpected outcomes.

To make the whole more understandable, we have throughout this book regarded secured credit as a system, with subsystems that work together to accomplish the system's principal goal. That goal is to facilitate credit extentions and dealmaking, and, by so doing, to encourage economic activity.

To the extent the system succeeds in doing that, it does so in two ways. First, it provides secured creditors with a coercive remedy—repossession and resale of collateral—that does not destroy too much of the value of the collateral in the process. The existence of a coercive remedy encourages debtors to pay voluntarily. The principal subsystems that provide this remedy are:

1. *Procedures for creating security interests.* This subsystem consists of laws, forms, and (dare we say it?) rituals used by debtors and their creditors to elevate claims to secured status.
2. *Rules authorizing self-help repossession.* U.C.C. §9-609 and case law construing its predecessor establish a right, available only to creditors with secured status, to repossess their collateral, as well as procedures by which to do so.
3. *State remedies system.* State governments provide systems by which government officials declare foreclosures, repossess collateral, and sell the collateral for the benefit of secured creditors. All of this is accomplished pursuant to judicial orders and procedures established by law.
4. *Bankruptcy system.* The federal government provides a bankruptcy system in which bankruptcy judges, bankruptcy trustees, and other officials ensure the preservation of secured creditors' collateral while the debtor continues to use the collateral or the bankruptcy officials liquidate it. While these bankruptcy procedures overlap and duplicate those of the older state remedies system, they are less rigid and therefore more effective than those of the state remedies system.

The second manner in which the secured credit system facilitates credit extension is by letting extenders know, before they commit, what priority or rights in the collateral they will have against third parties in the event of default. Here, three subsystems are at work:

1. *Public record systems.* Federal, state, and local governments operate thousands of public record systems in which various kinds of secured

parties are required to "file" or "record" their interests in order to perfect them. The records in these systems are indexed by public officials and then searched by later lenders who seek to discover the security interests, if any, that will have priority over the ones they themselves plan to take.

2. *Rules of priority.* State law, including Article 9 of the Uniform Commercial Code and thousands of statutory lien laws, contains rules intended to govern priority in competitions between particular kinds of claimants to collateral. Federal law provides additional rules of priority in the areas of bankruptcy, taxation, patents, trademarks, copyrights, admiralty, and others. These rules are interpreted, reconciled, and enforced in state, federal, and bankruptcy courts and, of course, in private negotiations between competing parties.
3. *Bankruptcy lien avoidance.* Secured creditors frequently fail to satisfy the complex technical requirements to perfect their interests. These failures result in relatively few challenges by competing creditors. Bankruptcy law fills the gap by appointing a person to serve as "trustee" in the bankruptcy case, arming that person with the rights of a hypothetical aggrieved lien creditor and providing incentives for the trustee to challenge any security interest that may be vulnerable. From a systems perspective, the effect is to greatly increase the level of enforcement and contentiousness in the system. That in turn increases the incentives for secured creditors to comply with the technicalities of the system, as well as providing jobs for lawyers.

As may already be apparent, the systems approach we employ in this book looks at more than just law. Law is one of the many elements that together constitute the secured credit system. To teach the law without teaching the system in which it is embedded would deprive the law of much of its meaning and make it more difficult to understand. But to teach the whole system requires discussion of institutions, people, and things that are not "law." Among them are sheriffs, bankruptcy trustees, filing systems, security agreements, financing statements, search companies, Vehicle Identification Numbers, closing practices, collateral repurchase agreements, and a variety of other commercial and legal practices. Together with law from a variety of sources, these things constitute the system we know as secured credit and the subject of this course. If you would like to know more about the systems approach, see Lynn M. LoPucki, The Systems Approach to Law, 82 Cornell L. Rev. 479 (1997).

Much of the law governing secured transactions is in Article 9 of the Uniform Commercial Code. That article was revised in 1998. All 50 states have adopted the revision. In all but a few states the effective date was July 1, 2001. Some of the U.C.C. cases in this book were decided under former Article 9, but all apply rules that remain the same under revised Article 9. Where sections numbers differ between the former and revised versions, we have substituted the revised numbers and placed them in brackets.

We have tried to include in each assignment all of the information needed to answer the problems at the end. The problems in a set are presented roughly in the order of their difficulty. The most difficult problems are in

practice settings. Many of them are sufficiently complex to challenge even lawyers who have been practicing commercial law for many years. Our assumption is that each member of the class, working alone or perhaps with one or two others, will find a satisfying solution before class. In class, students will present and discuss a variety of solutions and then attempt to settle on one or two that seem best. The process is not unlike that followed in most large law firms when several lawyers meet to brainstorm and formulate case strategy. Like most lawyers, we think that such sessions are the most challenging, intellectually exciting, and fun parts of law practice.

Lynn M. LoPucki
Elizabeth Warren

November 2008

I don't know as I want a Lawyer to tell me what I cannot do.
I hire him to tell me how to do what I want to do.

—J. P. Morgan

Secured Credit

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