



# Secured Credit A Systems Approach

Fourth Edition

**Lynn M. LoPucki**

Security Pacific Bank Professor of Law  
UCLA Law School

**Elizabeth Warren**

Leo E. Gottlieb Professor of Law  
Harvard University

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# Secured Credit

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For Walter O. Weyrauch

— L.M.L.

For Amelia Warren and Alexander Warren, who remind me  
forcefully to consider the student's perspective

— E.W.

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# Introduction

In the movie *Wall Street*, the neophyte stock broker 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 by large companies, student loans, loans between friends, trade credit (a business’s purchase of inventory on credit), and the loans by commercial banks and insurance companies.

Credit is secured by property of the debtor when the debtor and creditor have so agreed in an authenticated record. We speak of the secured creditor as having a lien against the property that serves as collateral. The lien, we say, secures the repayment of the debt. The significance of being secured is that secured creditors have a special set of collection rights. Principal among those rights are remedies not available to unsecured creditors and an entitlement to priority over other creditors in the collateral. Priority is the right to have the value of the collateral applied to the creditor’s own debt when the value of the collateral is insufficient to pay everyone.

That is not to say that security is merely about collecting debts. Security’s greatest importance is the power it confers on those who have it, even in transactions that never reach the collection stage. Readers who have given mortgages on their homes or security interests in their cars will know what we mean.

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 unsecured creditors against their debtors so the reader will have 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 debtors in the absence of bankruptcy. In Assignments 6 and 7, we explain how filing bankruptcy immediately interrupts, and ultimately alters, those 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 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 gives the reader the opportunity to bring together what he or she has learned in that Part.

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 advanced public notice of their existence. 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 those chapters we discuss the various kinds of competitors for collateral, one 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 reader has learned 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 who law helps, who 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 lending and, by so doing, to encourage desirable 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 work to 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 and procedures by which to attempt 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 assure 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 lending is by letting lenders know before they lend 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 of 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. The revisions are effective in all fifty states. In all but a few states the effective date was July 1, 2001. Former Article 9 will continue to affect the rights of some litigants for several years and problems of transition are inevitable. Many of the basic concepts are the same in both versions. We have chosen to focus almost exclusively on the revised text. While experienced Article 9 mavens will pride themselves in knowing the details of both versions, the new text will probably govern the vast bulk of Article 9 practice for this generation of law students while the largely repealed text of former Article 9 will slip quickly into the past.

We have tried to include in each assignment all of the information the reader will need to answer the problems at the end. The problems in a set are presented roughly in the order of their difficulty. (In a few of the assignments, there are more problems than necessary. Your teacher will instruct you which to omit.) 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 get together for a brainstorming session to formulate strategy for a particular case. Like most lawyers, we think that such sessions are not only the most challenging, but also the most intellectually exciting and fun parts of the practice of commercial law.

Lynn M. LoPucki  
Elizabeth Warren

October 2002

# Secured Credit

# Summary of Contents

<i>Contents</i>	<i>xi</i>
<i>Acknowledgments</i>	<i>xiii</i>
<i>Introduction</i>	<i>xxv</i>

## Part One

### The Creditor-Debtor Relationship 1

#### Chapter 1. Creditors' Remedies Under State Law 3

Assignment 1: Remedies of Unsecured Creditors Under State Law	3
Assignment 2: Security and Foreclosure	21
Assignment 3: Repossession of Collateral	37
Assignment 4: Judicial Sale and Deficiency	59
Assignment 5: Article 9 Sale and Deficiency	80

#### Chapter 2. Creditors' Remedies in Bankruptcy 95

Assignment 6: Bankruptcy and the Automatic Stay	95
Assignment 7: The Treatment of Secured Creditors in Bankruptcy	115

#### Chapter 3. Creation of Security Interests 135

Assignment 8: Formalities for Attachment	135
Assignment 9: What Collateral and Obligations Are Covered?	155
Assignment 10: Proceeds, Products, and Other Value-Tracing Concepts	168
Assignment 11: Tracing Collateral Value During Bankruptcy	183
Assignment 12: The Legal Limits on What May Be Collateral	196

#### Chapter 4. Default: The Gateway to Remedies 217

Assignment 13: Default, Acceleration, and Cure Under State Law	217
Assignment 14: Default, Acceleration, and Cure Under Bankruptcy Law	239

#### Chapter 5. The Prototypical Secured Transaction 253

Assignment 15: The Prototypical Secured Transaction	253
---	-----

<b>Part Two</b>	
<b>The Creditor-Third Party Relationship</b>	<b>273</b>
<b>Chapter 6. Perfection</b>	<b>275</b>
Assignment 16: The Personal Property Filing Systems	275
Assignment 17: Article 9 Financing Statements: The Debtor's Name	294
Assignment 18: Article 9 Financing Statements: Other Information	312
Assignment 19: Exceptions to the Article 9 Filing Requirement	327
Assignment 20: The Land and Fixtures Recording Systems	345
Assignment 21: Characterizing Collateral for the Purpose of Perfection	361
<b>Chapter 7. Maintaining Perfection</b>	<b>375</b>
Assignment 22: Maintaining Perfection Through Lapse and Bankruptcy	375
Assignment 23: Maintaining Perfection Through Changes of Name, Identity, and Use	390
Assignment 24: Maintaining Perfection Through Relocation of Debtor or Collateral	403
Assignment 25: Maintaining Perfection in Certificate of Title Systems	415
<b>Chapter 8. Priority</b>	<b>433</b>
Assignment 26: The Concept of Priority: State Law	433
Assignment 27: The Concept of Priority: Bankruptcy Law	446
<b>Chapter 9. Competitions for Collateral</b>	<b>463</b>
Assignment 28: Lien Creditors Against Secured Creditors: The Basics	463
Assignment 29: Lien Creditors Against Secured Creditors: Future Advances	472
Assignment 30: Trustees in Bankruptcy Against Secured Creditors: The Strong Arm Clause	486
Assignment 31: Trustees in Bankruptcy Against Secured Creditors: Preferences	507
Assignment 32: Secured Creditors Against Secured Creditors: The Basics	519
Assignment 33: Secured Creditors Against Secured Creditors: Land and Fixtures	535

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Assignment 34: Competitions Involving Cross-Collateralization and Marshaling Assets	555
Assignment 35: Sellers Against Secured Creditors	574
Assignment 36: Buyers Against Secured Creditors	592
Assignment 37: Statutory Lien Creditors Against Secured Creditors	609
Assignment 38: Competitions Involving Federal Tax Liens: The Basics	630
Assignment 39: Competitions Involving Federal Tax Liens: Advanced Problems	648
Assignment 40: Why Secured Credit?	663
<i>Table of Cases</i>	683
<i>Table of Statutes</i>	689
<i>Index</i>	697



# Contents

*Acknowledgments*  
*Introduction*

xxiii  
xxv

## Part One

<b>The Creditor-Debtor Relationship</b>	<b>1</b>
<b>Chapter 1. Creditors' Remedies Under State Law</b>	<b>3</b>
<b>Assignment 1: Remedies of Unsecured Creditors Under State Law</b>	<b>3</b>
A. Who Is an Unsecured Creditor?	3
B. How Do Unsecured Creditors Compel Payment?	4
<i>Vitale v. Hotel California, Inc.</i>	5
C. Limitations on Compelling Payment	13
<i>Wisconsin Statutes Annotated</i>	15
D. Is the Law Serious About Collecting Unsecured Debts?	17
Problem Set 1	18
<b>Assignment 2: Security and Foreclosure</b>	<b>21</b>
A. The Nature of Security	21
<i>The Invention of Security: A Pseudo History</i>	23
<i>Basile v. Erhal Holding Corp.</i>	27
B. Foreclosure Procedure	29
1. Judicial Foreclosure	29
<i>Wisconsin Statutes Annotated</i>	32
2. Power of Sale Foreclosure	33
3. U.C.C. Foreclosure by Sale	34
Problem Set 2	34
<b>Assignment 3: Repossession of Collateral</b>	<b>37</b>
A. The Importance of Possession Pending Foreclosure	37
B. The Right to Possession Pending Foreclosure—Real Property	38
1. The Debtor's Right to Possession During Foreclosure	38
2. Appointment of a Receiver	38
<i>California Code of Civil Procedure</i>	40
<i>Illinois Mortgage Foreclosure Law</i>	40
3. Assignments of Rents	41
C. The Right to Possession Pending Foreclosure—Personal Property	41
<i>Del's Big Saver Foods, Inc. v. Carpenter Cook, Inc.</i>	42
D. The Article 9 Right to Self-Help Repossession	46
E. The Limits of Self-Help: Breach of the Peace	47
<i>Salisbury Livestock Co. v. Colorado Central Credit Union</i>	48
F. Self-Help Against Accounts as Collateral	52
Problem Set 3	55