LOPUCKI
WARREN

SECURED CREDIT
A Systems Approach

Fourth Edition

ASPEN
PUBLISHERS

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

ASPEN
PUBLISHERS

1185 Avenue of the Americas, New York, NY 10036
www.aspenpublishers.com

Permissions
Aspen Publishers
1185 Avenue of the Americas
New York, NY 10036

Printed in the United States of America

1 2 3 4 5 6 7 8 9 0

Library of Congress Cataloging-in-Publication Data

LoPucki, Lynn M.
Secured credit : a systems approach / Lynn M. LoPucki, Elizabeth Warren.—4th ed.
p. cm.
Includes index.
ISBN 0-7355-3646-5
1. Debtor and creditor—United States—Cases. 2. Security (Law)—United States—Cases. 3. Bankruptcy—United States—Cases. I. Warren, Elizabeth. II. Title.

KF1501.A7 L65 2002
346.7307'7—dc21

2002034228

Secured Credit

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.

Acknowledgments

We are deeply indebted to Jay L. Westbrook, University of Texas School of Law, for his intellectual contributions to this book. Jay deserves credit as a codeveloper of what we here call "the systems approach." Many of our colleagues contributed to this edition by making comments on earlier editions. They include:

Allan Axelrod, Rutgers-Newark Center for Law & Justice
John D. Ayer, University of California at Davis Law School
Roger Bernhardt, Golden Gate University School of Law
Beth Buckley, SUNY Buffalo School of Law
Amy C. Bushaw, Lewis & Clark, Northwestern School of Law
Robert Chapman, Willamette University College of Law
Kathryn R. Heidt, University of Pittsburgh Law School
Margaret Howard, Washington and Lee University School of Law
Sarah Jane Hughes, Indiana University School of Law-Bloomington
Melissa B. Jacoby, Temple University School of Law
Daniel L. Keating, Washington University School of Law
Kenneth C. Kettering, New York Law School
Jason J. Kilborn, Louisiana State University Law Center
Charles Lincoln Knapp, New York University School of Law
Michael M. Korybut, Saint Louis University School of Law
Ronald J. Mann, University of Michigan Law School
Bruce Markell, University of Nevada, Las Vegas School of Law
F. Stephen Knippenberg, University of Oklahoma Law Center
Steven L. Sepinuck, Gonzaga University School of Law
Paul M. Shupack, Yeshiva University, Cardozo School of Law
Catherine Tinker, University of South Dakota School of Law
Stephen J. Ware, Cumberland School of Law
G. Ray Warner, University of Missouri-Kansas City School of Law
Zipporah B. Wiseman, University of Texas School of Law
William J. Woodard, Jr., Temple University School of Law

We are indebted to them, their students, and our own students at the University of Pennsylvania, Harvard, Washington University, the University of Wisconsin, Cornell, and UCLA both for improving the book and for putting up with our errors, both substantive and typographical.

Numerous people who work in the secured credit system were kind enough to answer our questions about the system and otherwise provide information. They include Naran U. Burchinow, General Counsel for Deutsche Financial Services; Carl Ernst, President of UCC Filing Guide, Inc.; Jerry Grossman, at Heller, Erhman, White, and McAuliffe, San Francisco, California; and Ed Hand, UCC Filing and Search Services, Tallahassee, Florida. Joanne Margherita and Karen Mathews served as desktop publishers and manuscript organizers. Barbara Smith, Bill Cobb, Cathy Stites, and

Heather Suve provided valuable assistance with research. While our work was in progress, Peter Benvenutti's bankruptcy department at Heller, Ehrman, White, and McAuliffe sheltered one of the authors from the dark, bitter cold of two Wisconsin winters under the rubric "Scholar-in-Residence" and made available the resources of the firm.

The following have granted permission to reprint:

The New York Times for permission to reprint portions of David Margolick, At the Bar, A Maine Lobsterman's Justice, N.Y. Times, Sept. 17, 1993.

North American Syndicate for special permission to reprint the Dunagin's People cartoon that appears in Assignment 35.

The Virginia Law Review for permission to reprint portions of Lynn M. LoPucki, The Unsecured Creditor's Bargain, 80 Va. L. Rev. 1887 (1994).

James J. White and the Loyola of Los Angeles Law Review for permission to reprint portions of James J. White, Revising Article 9 to Reduce Wasteful Litigation, 26 Loy. L.A. L. Rev. 823 (1993).

Deutsche Financial Services for permission to reprint portions of the Security Agreement and Floorplan Agreement that appear in Assignment 15.

Matthew Bender & Co. for permission to reprint the security agreement default provisions from Howard Ruda, Asset-Based Financing.

Anthony B. Kronman, Fred B. Rothman & Company, and the Yale Law Journal for permission to reprint portions of Thomas H. Jackson and Anthony Kronman, Secured Financing and Priorities Among Creditors, 88 Yale L.J. 1143,1147-1148 (1979).

Robert E. Scott and the Columbia Law Review for permission to reprint portions of Robert E. Scott, A Relational Theory of Secured Financing, 86 Colum. L. Rev. 901, 904-911 (1986).

Steven L. Harris, Charles W. Mooney, Jr., Fred B. Rothman & Company and the Virginia Law Review for permission to reprint portions of Steven L. Harris and Charles W. Mooney, Jr., A Property-Based Theory of Security Interests: Taking Debtor's Choices Seriously, 80 Va. L. Rev. 2021, 2021-2023, 2047-2053 (1994).

Donald B. Dowart for permission to reprint Donald B. Dowart, Memorandum: Priorities of Maritime Lien and Preferred Ship Mortgages, Feb. 9, 1993.

The Cornell Law Review for permission to reprint Elizabeth Warren, Making Policy with Imperfect Information: The Article 9 Full Priority Debates, 81 Cornell L. Rev. 1373 (1997).

Fred B. Rothman & Company and the Yale Law Journal for permission to reprint portions of Lynn M. LoPucki, The Death of Liability, 106 Yale L.J. 1 (1996).

Ronald J. Mann and the Georgetown Law Journal for permission to reprint portions of Ronald J. Mann, The Role of Secured Credit in Small-Business Lending, 86 Geo. L.J. 1 (1997).

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

Part Two

Contents