**Secured Transactions Basics**

Welcome to this podcast on Secured Transactions Basics brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is the nature of security interests, as well as some of the basic vocabulary that you will need to understand the concepts. Like in many areas of the law, a thorough understanding of secured transactions requires you to use the correct vocabulary relevant to the topic. Here we are using the rules set forth in the Uniform Commercial Code Article 9. The rules of Article 9 are state statutory law. The Official Comments to the rules are intended to be informative and they are highly persuasive, but they are not part of the state statute because they are not enacted by the legislature. Additionally, we will also sometimes refer to the rules of Article 1 of the UCC, as Article 1 contains general provisions and vocabulary applicable to all parts of the Code. The primary terms of art associated with security interests are generally defined in either 1-201 or 9-102, though some definitions are contained elsewhere. This podcast primarily focuses on security interests created under Article 9, leaving for other study mortgages and statutory and judicial liens.

Let’s begin with the nature of a security interest. According to § 1-201(37) a security interest means an interest in personal property or fixtures which secures payment or performance of an obligation. Simply put, we are looking at consensual relationships creating an interest in personal property that is somehow contingent on the nonpayment of a debt obligation and then foreclosure by the creditor. In the world of real property, we refer to this interest as a mortgage.

You might ask, what does that mean when it comes to personal property? Suppose I want to buy a clarinet for my young son Marshall. There are a number of ways that I can purchase this clarinet. If I have cash, I can pay for the clarinet and take it home. The transaction is done. Alternatively, I might pay for the clarinet with a credit card. Still further, Music City, the seller of the clarinet, might agree to sell me the clarinet on credit with Music City taking an interest in the clarinet to secure payment of $50 per month over three years for the clarinet. In this situation, it sounds like Music City seeks to create a security interest in the clarinet. That is, an interest in personal property, the clarinet, to secure payment of the obligation, the $50 per month. You might imagine a security interest attaching like an invisible string to the personal property, the clarinet, such that the obligation to pay is now tied to the clarinet. While paying with cash or a credit card would not create a separate interest in the clarinet, it appears that the credit transaction with Music City would create a security interest, thereby attaching the invisible string between the obligation to pay and the clarinet itself. This invisible string is the security interest.

But what about other terms of art? In the hypothetical involving Music City, the clarinet is referred to as *collateral*. At its simplest, this just means the clarinet is the personal property that is subject to the security interest. Moreover, I would be called the *borrower*, *obligor*, or simply the *debtor*. A debtor is a person having an interest in the collateral, whether or not the person is also an obligor. The obligor is the person who actually owes payment or other performance of the obligation. The obligation is, of course, the payment of the $50 per month to Music City. Music City would be called the lender or the creditor.

Of course you could have a less common situation where the debtor is not also the obligor. Suppose my friend Scott wants to buy a trumpet from Music City on credit and while he agrees to pay the $50 each month to Music City for three years, I agree to put up Marshall’s clarinet as collateral. In that transaction, I am the debtor, but Scott is the obligor.

So, how would Music City go about the business of creating a security interest? Well, in a typical case, I would sign a promissory note promising to pay Music City $50 per month for 36 months. The promissory note documents the obligation to pay for the clarinet. Notice that the promissory note itself does not create a security interest. This is very important. In most cases, Music City and I would also sign a security agreement. A security agreement is simply an agreement that creates or provides for a security interest. It is the security agreement that attaches the invisible string to the clarinet. It is the security interest that changes a creditor from being an unsecured creditor, like a credit card company, to being a secured creditor. It is important that the security agreement identify the collateral, in this case the clarinet. Article 9 permits secured creditors to take a number of different kinds of personal property as collateral and to identify the collateral specifically, like the clarinet, or even generally using categories set forth in Article 9, such as equipment, accounts, and inventory. It is the specification of the collateral that tells us which items of the debtor’s personal property are attached by the string and which ones are not. As it turns out, Article 9 has separate rules for many of these categories. Note that the collateral does not have to be the thing being sold. Music City is perfectly free to negotiate for a security interest in my existing piano when extending me credit to buy the clarinet.

You might ask what comes next? You may recall in real property, lenders will protect their interests by making filings that give notice to others of their mortgage. In the area of secured transactions, there is also a filing system. Creditors typically file a one page form called a *financing statement*. Sometimes students will erroneously say financial statement but that is not correct. The correct term is financing statement, sometimes called a UCC-1 after the model form promulgated by Article 9. The financing statement contains the relevant information about the transaction, the parties, and the collateral involved. It gives notice to other claimants that the clarinet is subject to the security interest of Music City.

But why go to all this trouble? Does it actually help to be a secured creditor? Sure. We’ve imagined an invisible string attached to the clarinet by Music City, a secured creditor. If I pay $50 per month for three years as I promised, I will keep the clarinet without incident. But what if I stop paying? What if Marshall doesn’t play the clarinet anymore? He’s moved on to other activities. Or, I just don’t have the money to pay Music City. There are many reasons that a debtor may not pay the full obligation. What can Music City do? In the event that the debtor failed to pay, which would be a *default* on the promissory note and security agreement, the status as a secured creditor will provide rights under Article 9. We generally say that a secured creditor has priority over an unsecured creditor. A secured creditor might also have priority over other secured creditors, as you can see in other parts of Article 9. It is this concept of priority that is the incentive for secured creditors to create a security interest in the first place.

In the event that I failed to pay for the clarinet as promised, Article 9 permits a secured party to enforce the interest by taking possession of the clarinet either through judicial or non-judicial process. This is commonly called *foreclosure.* In most instances, the creditor will attempt to satisfy the obligation after repossession by selling the collateral, here the clarinet. If the sale proceeds are sufficient to pay the obligation, then the creditor is made whole. If the sale proceeds are insufficient to pay the obligation, then the creditor will claim a *deficiency*. A deficiency is the amount by which the sale proceeds fell short of full repayment on the obligation owed. With respect to any deficiency, the creditor would be unsecured as there is no collateral for this portion of the obligation. In the rare case that the sale of the clarinet yielded more money than the obligation, this is called a *surplus*. Any surplus is paid to the borrower after full payment of the obligation plus any expenses incurred in repossession.

In order for Music City to become a secured creditor, its security interest must attach to the clarinet. Without that secured status, Music City is called an unsecured creditor. But, what does that mean to Music City? Well, if I purchase the clarinet from Music City with a promissory note whereby I promise to pay $50 per month for three years, but there is no security agreement, then there is no security interest. Basically, the invisible string that we’ve imagined tying the obligation to the clarinet is not present. In such cases, the creditor is unsecured and has no right to claim the clarinet. The creditor could seek a money judgment and then try to enforce the judgment against the borrower. However, if there are secured creditors ahead of it in line, or if the borrower declares bankruptcy, the unsecured creditor is likely to be out of luck.

In the end, a creditor such as Music City will want to be a secured creditor in order to protect its position in advance of any potential default by the debtor. This involves understanding the rules of Article 9 and its requirements to create a security interest, perfect the interest, and then enforce the interest. Each of these concepts has special rules set forth in the provisions of Article 9.

At this point, you should be able to recognize the following vocabulary and use it correctly: security interest, attach, debtor, creditor, obligation, collateral, promissory note, security agreement, financing statement, priority, default, and possession.

I hope you’ve enjoyed this podcast on Secured Transactions Basics.

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