The Security Interest

I. Creating the Security Interest

A. Formalities for Attachment [§ 9-203(b)]: All three of the following must be satisfied for a security interest to become binding between the debtor and the secured creditor.

1. Value Given [§ 9-203(b)(1)] – Essentially, consideration given by the SC to bind the debtor to the SI.
   a. “Value” is defined in § R1-204 so broadly that it rarely excludes anything other than “sham” transactions
   b. “Value” encompasses all forms of consideration that would support an ordinary contract, it even includes past consideration

2. Debtor has Rights in the Collateral [§ 9-203(b)(2)]: A debtor cannot grant a SI in property in which he has no rights. However, that does not mean debtor must own property.
   a. If debtor owns a limited interest in the asset and grants an SI in the asset, the SI will generally attach only to the debtor’s interest
   b. Some debtors who acquired their limited interest by fraud may be able to grant a bona fide purchaser (defined to include a SC) ownership rights the debtor does not have.

3. Writing, Possession, Delivery, or Control [§ 9-203(b)(3)]
   a. Writing [§ 9-203(b)(3)(A)]
      i. It must describe the collateral (and, if the collateral is timber to be cut, describe the land on which it is situated).
      ii. The debtor must authenticate it.
         ♦ “Authenticate” includes symbols, encryption, and similar acts “with the present intent of the authenticating person to ... adopt or accept [the] record” § 9-102(7)
iii. A written security agreement should also contain

a). a description of primary debt(s)/obligation(s),

b). conditions of default,

c). the SC’s rights/remedies on default, and

d). any other undertakings of the debtor, such as maintenance, insurance, etc.

iv. “Composite Document Rule”: SOF can be satisfied by reading more than one document together

b. Possession [§ 9-203(b)(3)(B)] – May be actual or constructive, as long as, if latter, the person in actual possession is under the SC’s control by operation of law or by agreement

c. Delivery – only applies to “certificated securities” (see § 9-203(b)(3)(C))

d. Control – § 9-203(3)(D) authorizes control of deposit accounts, electronic chattel paper, letter-of-credit rights, and investment property

B. Time of Attachment [§ 9-203(a)]: Because all three formalities must be satisfied for the SI to attach, the SI will not attach until the last formality is satisfied.

C. Descriptions of Collateral

1. Items of Collateral (e.g., “my 26-ft. Bassmaster fishing boat”)

2. Types of Collateral

   a. Accounts [§ 9-102(2)]

   b. Consumer Goods [§ 9-102(23)]

   c. Equipment [§ 9-102(33)]

   d. Farm Products [§ 9-102(34)]

   e. General Intangibles [§ 9-102(42)]

   f. (Negotiable) Instruments [§ 9-102(47)]

   g. Inventory [§ 9-102(48)]
3. Must enable interested parties to **reasonably identify** the collateral.

4. Two Questions:
   
a. Does the adequacy of a description depend on whether the dispute is between the debtor and the SC or between the SC and a third party?

   b. To what degree can a description of collateral refer to information not contained in the SA without failing for indefiniteness?

5. § 9-108(c) provides: “A description of collateral as ‘all the debtor’s assets’ or ‘all the debtor’s personal property’ or using words of similar import does not reasonably identify the collateral.”

   ♦ As we will see later in the course, while such a “supergeneric” description of the collateral in the SA is insufficient for the SA to attach, a “supergeneric” description of the collateral in a financing statement, filed to give notice to third parties of the SC’s interest in the debtor’s assets, is sufficient. *See § 9-504(2).*

6. **After-Acquired Property**: Property, of the same kind as is covered by an SI, that the debtor acquires after the SI is created.

   a. Article 9 approves of “after-acquired property” clauses. *See § 9-204(a).*

   b. Typically, AAP clauses cover inventory or accounts receivable

   c. In the absence of an AAP clause, SC risks not being able to claim AAP as collateral – becomes an issue of “interpretation”

D. **Descriptions of Obligations Secured**

1. SI can secure a debt that does not yet exist, but which the parties contemplate will come into existence in the future.

2. **Future Advances**: debt that comes into existence as a result of the extension of credit by the SC. *§ 9-204(c)*

3. **Dragonet Clause**: description of collateral in SA that includes future advances

4. SA typically includes SC’s attorneys’ fees and expenses of collection in the event of default and authorizes SC to add these amounts to the secured debt
E. **Interpreting Security Agreements**

1. SA is a contract between the debtor and SC; therefore, it is interpreted like any other contract
2. SA can “bind” third parties as well, to the extent that a perfected SA gives the SC “priority” over the third parties
3. UCC definitions generally control – when the parties use a term in the SA (or FS) that has a particular meaning under the UCC, courts generally give the term its Art. 9 meaning rather than its “common” meaning

II. **Value Tracing**

A. **Five Basic Value-Tracing Concepts in the UCC:** SIs can be structured so they can live on after collateral has been consumed.

1. **Proceeds:** SI in value gained by debtor in disposing of collateral (may be $$, other goods, instrument, etc.)
2. **Product:** SI in asset made by or of the collateral (e.g., apples, wool)
3. **Profit** – Two types:
   a. **“economic” profit** = revenues – cost (i.e., profit generated by the product)
   b. **profit a prendre** = right to take product specifically from the land (e.g., timber, oil)
4. **Rent:** use of value of collateral/$$ paid for same
5. **Offspring:** baby animals (e.g., lambs)

B. **Claiming SI in Non-Proceeds:** SI in collateral automatically attaches to proceeds of that collateral, but what about product, etc.?

   ♦ Need to be specified in SA to make sure you have a SI.
   ♦ All can tie together – e.g., can take SI in the profit of offspring.

C. **More on Proceeds**

1. **What are Proceeds?** Whatever is received on the sale, exchange, collection, or other disposition. § 9-102(64)
a. **Exchange**: SI in cash becomes SI in computer purchased with the cash.

b. **Collection**: Money collected on accounts receivable = proceeds of A/R.

c. **Other Dispositions**: Include “use” value of a lease. § 9-102(64)(A).

2. **Proceeds of Proceeds.** See § 9-306 cmt. 13.c.

3. **Automatic SI in Proceeds**: UCC presumes that a SI in collateral includes SI in proceeds of collateral, unless the parties specifically exclude proceeds. §§ 9-203(f) & 9-315(a)(2).

4. **Sale of Collateral**: What happens to SI when collateral is sold depends on if the SI allows a sale or not.

   a. If **authorized** (specifically or in security agreement): UCC presumes that secured creditor has agreed to give up SI in the physical collateral & accept the proceeds instead.

      ♦ Sale is “free and clear” of SI

   b. If **unauthorized**: As long as debtor pays debt, it doesn’t really matter. But if debtor doesn’t pay debt, then SC retains SI in collateral & gets SI in proceeds of the sale as well.

      ♦ If debtor defaults, secured creditor can take collateral from third-party buyer.

      ♦ In some states, debtor goes to jail. Illegal to sell without approval = stealing from secured creditor.

      ♦ If SC only has contingent interest in collateral, isn’t criminal penalty excessive? In essence, debtor is punished for merely depriving SC of insurance it may never need. A bit harsh for a breach of k.

5. **Tracing Problems**: What if the proceeds of sale are not readily identifiable (i.e., I can’t tell my money from debtor’s other money)?

   ♦ **Lowest intermediate balance rule**: See how much in account when proceeds are deposited. Check balance on date we claim proceeds. The lowest ending daily balance is what secured creditor now has secured interest in if less than what is owed. The rest of debt becomes unsecured.
D. **Value-Tracing Concepts vs. Non-Value Tracing Concepts** (e.g., AAP, “Additions,” “Replacements,” “Substitutions”)

1. **VTCs** all arise, in whole or in part, from the original collateral

2. **AAP, etc.** come from another source (as long as not paid for w/ proceeds)