CHAPTER ONE

Introduction

Secured transactions are at once obscure—tell people that you teach or are taking a course in secured transactions and you are sure to get a blank stare—and ubiquitous. Buy a house using borrowed money, and you almost certainly will enter into a secured transaction in real property. Buy a car and finance it through GMAC, General Motor's finance arm, and you will have entered into a second secured transaction, this time in personal property. Secured transactions range from a $10 loan at the local pawnshop secured by a pledge of a ring, to the lien on the car held by GMAC, to multibillion-dollar loans secured by all of a firm's assets. In each of these transactions, a borrower posts collateral to a lender to facilitate the loan. The idea of giving collateral in personal property—or, in language we will quickly adopt, of granting a security interest—and its consequences are the focus of this book.

This book then addresses the subject of secured transactions in personal property. Note the focus on "personal property," meaning, of course, property other than real estate. A corporation can own personal property, and indeed part of what makes secured lending interesting is the billion-dollar secured transaction involving corporate personal property. Notwithstanding the focus on personal property, you should not think for a minute that secured transactions in real property are unimportant. Quite the opposite. At any given time in the United States, several trillion dollars in outstanding loans are secured by mortgages on real property. Rather, the focus of this book reflects the scope of the law applicable to secured transactions. Different laws apply to lending against real and personal property. With some exceptions, most notably the federal Bankruptcy Code, most of the relevant law is state law. State laws on secured transactions in real property vary widely. Although common elements can be identified across the states, no single scheme, or perhaps more importantly, no single legal text, predominates.

Happily, the situation is far different for lending against personal property. Article 9 of the Uniform Commercial Code on Secured Transactions has formed the basis for the laws on the subject in each of the fifty states. It is therefore possible to offer a comprehensive introduction to the law of secured transactions in personal property in the United States in a book that weighs less than five pounds.

After a quick look at the status of an unsecured creditor, this chapter lays out the basic infrastructure created by Article 9. The nature of such an undertaking is that it inevitably omits details. In the law, details matter—some would say details are everything in the law—and, unfortunately, details may matter more in secured transactions than they do in most areas of the law. It will nonetheless be easier to absorb these details if the basics are well-understood.

Section I. The Life of the Unsecured Creditor

It is difficult to comprehend what it means to be a secured creditor without understanding the life of the unsecured creditor. So start with a concrete situation. Debtor is in the widget business, and, as would be true of a business of any size, many assets are required to run it. Debtor uses a patented process and special equipment to turn raw material into widgets. Debtor sells the widgets under its trademark, sometimes for cash, sometimes on credit. The promises made by customers to pay constitute Debtor's accounts receivable.

On February 1st, Debtor approaches Bank for a loan of $10,000. If Bank lends on an unsecured basis, only two steps are required: money is lent by Bank to Debtor and Debtor promises to repay it. Oh sure, there will be lots of paper—promissory notes to evidence Debtor's obligation to repay and to set interests rates, other fees and a repayment schedule, and perhaps even a detailed loan agreement. Nonetheless, the basics of an unsecured loan are the lending of money and a promise to repay it, and nothing more.

Assume that Bank makes an unsecured loan of $10,000 and that the full amount of the loan, plus simple interest at 10%, is due in one year. The following February 1st, Bank seeks to collect its $11,000. If all goes well, Debtor cheerfully pays in full, and we can stop. Matters are more interesting if Debtor cannot pay. One question is obvious: What rights does

Bank have against Debtor? A second question is less obvious: What rights does Bank have relative to Debtor's other creditors?

Start with the first question. If Bank was careful, it checked before making its loan to confirm that Debtor had substantial assets. Debtor has refused to turn over any of those assets to Bank. Unless the debtor is just being spiteful, the debtor is almost surely in financial trouble. In most commercial dealings, in the absence of a dispute over performance of a contract, parties rarely simply refuse to pay, unless they are in financial trouble. Bank will seek to collect its debt under applicable state law.

Although state laws differ in their details, the basic pattern is fairly standard. Bank cannot simply descend on Debtor and grab a widget machine. In making an unsecured loan, Bank received no special rights in any of Debtor's assets. Putting to one side pre-judgment remedies, a creditor typically cannot invoke the powers of the state to collect her debt until a money judgment has been issued in favor of the creditor. Consequently, Bank first must go to court to prove that Debtor owes Bank the money. This process—usually called "proving up a judgment"—often is little more than a formality, as Debtor may not even contest the judgment. Nonetheless, this first step requires going to court, with the attendant out-of-pocket costs and delay.

Bank now has a judgment in hand—and has become a *judgment creditor*—but what Bank really wants is cash. The judgment is an essential step, but Bank must take two more steps. Bank must deliver the judgment or another paper describing the judgment to the sheriff of the jurisdiction where Debtor's property is located. The sheriff, in turn, will then seize the property from the debtor, or will *levy* on it. The sheriff will sell the property pursuant to established procedures and will pay the creditor the proceeds of the sale, after deducting the sheriff's expenses.

It is quite improbable that Bank is the only creditor with a bone to pick with Debtor. Debtor's refusal to pay Bank in the face of Bank's willingness to sue suggests that Debtor is in financial trouble. Debtor's other creditors will also seek to collect their debts. The just-described process of judgment, delivery, levy and sale describes the rights of one creditor against a debtor, but says nothing of the rights of one creditor against other creditors. If the debtor is insolvent, the *relative* rights of the creditors will determine how much each gets paid.

In some states, priority is determined by the date of the judgment. The first creditor to get a judgment is entitled to payment first, up to the full amount of the judgment. In other states, a judgment creditor is protected against the competing claims of unsecured creditors or transferees, but more is needed to be protected against the claims of other creditors seeking priority. The judgment creditor becomes an *execution creditor* by delivering an official notice of the entry of the judgment—the *execution*—to the local sheriff. Once the execution has been delivered to the sheriff, the creditor will have taken all of the steps necessary to create a priority to much of the debtor's property. Priority among competing execution creditors is then determined by the time of delivery of the execution to the sheriff. Note that in either case—when priority is dated from entry of the judgment or from delivery of the execution to the sheriff—unsecured creditors race to the assets by jumping through the appropriate state law hoops. Each unsecured creditor must undertake a slow and expensive process, and the till may be empty when the creditor finally reaches in for its share.

This has been a contextless hypothetical; as law students, you expect these, but we should make these ideas more concrete, and the next case, a 5-4 decision from the U.S. Supreme Court, does exactly that.

Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.

United States Supreme Court, 1999.
527 U.S. 308.

■ JUSTICE SCALIA delivered the opinion of the Court.

This case presents the question whether, in an action for money damages, a United States District Court has the power to issue a preliminary injunction preventing the defendant from transferring assets in which no lien or equitable interest is claimed.

I

Petitioner Grupo Mexicano de Desarrollo, S.A. (GMD) is a Mexican holding company. In February 1994, GMD issued $250 million of 8.25% unsecured, guaranteed notes due in 2001 (Notes), which ranked *pari passu* in priority of payment with all of GMD's other unsecured and unsubordinated debt. Interest payments were due in February and August of every year. Four subsidiaries of GMD (which are the remaining petitioners) guaranteed the Notes. Respondents are investment funds which purchased approximately $75 million of the Notes.

taking in dissipating the assets? Also, can we answer this question in isolation, or should we consider the full set of choices available to a potential creditor?

3. What should we make of FRCP 18(b)? The parties didn't raise it and the Court notes that the FRCP is trumped by the provisions of the Rules Enabling Act. Should we think of the issue in *Grupo Mexicano* as being substantive or procedural?
4. Lawyers love the English, too, as you could not help but note the obsession with the English in this case. Is this ancestor worship, a historical accident, or something commanded by the relevant texts?
5. For a historical review of equity remedies and a critical appraisal of *Grupo Mexicano,* see Steven B. Burbank, The Bitter with the Sweet: Tradition, History, and Limitations on Federal Judicial Powers – A Case Study, 75 Notre Dame L. Rev. 1291 (2000).

SECTION II. READING THE UCC AND AIDS TO UNDERSTANDING

It is worth pausing to note what the Uniform Commercial Code is and is not. It is a model law promulgated by The National Conference of Commissioners on Uniform State Laws and the American Law Institute. Current responsibility for the Code rests in the main with the Permanent Editorial Board of the UCC, which in turn is comprised of representatives from the Conference and from the ALI. The UCC, which grew out of work commenced by Karl Llewellyn and Soia Mentschikoff in the 1940s, has evolved over time. Official versions are dated and the 1962 and 1972 official versions of Article 9 have been especially significant. Minor changes were made to the official version of Article 9 in 1987 to reflect the promulgation of Article 2A, covering leases of personal property. More substantial changes were made in 1994, when the revised version of Article 8 on securities was issued.

Most importantly, we have now entered a transition period for Article 9. In 1998, a substantially revised version of Article 9 was issued by the ALI and NCCUSL. This is the first major revision of the statute since 1972, and probably will establish the basic framework for Article 9 transactions for the next two or three decades. The unfortunate reality is that transitions from one official UCC to a second are quite difficult, and that is especially true in secured transactions, where it is contemplated that the arrangements between the parties will last for many years.

Start with the fact that as state law, each state will enact the new uniform statute at different times. This creates the possibility that some states will be operating under the old version, while some are using the new. Indeed, this is more than just a possibility: it is almost inevitable. The good news is that the vast majority of the states enacted Revised Article 9 before July 1, 2001, the date that it went effective. (You can find out the status in any state by going to NCCUSL's website at www.nccusl.org.) Beyond this, we have almost no caselaw under the new statute. Litigants will inevitably look to cases under the old statute when they make their cases. Students will need to read cases decided under the old statute until we have built up a stock of worthwhile new cases. We will all need to become adept at moving back and forth between the old statute and the new statute.

We can get quite concrete about how to do that. Pick up your copy of Article 9 and look at it. In addition to the table of contents, you will find two key tables. One is the table of dispositions. This shows where old sections have gone in the revised statute. So, if you decide tomorrow to read a case from 1994, you will see statutory references in that case, and you will need to map those references to the new statute. The table of dispositions helps you do this. The second table is the table indicating sources or derivations of new Article 9 sections and conforming amendments. Here is how this helps: you are looking at Article 9 and would like to do some research on a particular issue. You find no cases under the new section—and this will happen for some time—so you want to see if there are cases before the revision. You will use the table of derivations to map from the new statute to the old statute and from there to the cases.

In this book, as a matter of convention, most of the non-case references will be to the new statute. A reference to the old statute will say so, or will be indicated as F9-xxx. In contrast, the references in the cases will refer to the statute in place at the time that the case was decided, but we have added references in square brackets to refer to the corresponding provisions in the new statute. As you should now understand, all we have done is systematically used the table of disposition to save you the trouble of doing so.

If we haven't scared you off, the good news is twofold. First, with a handful of exceptions, most of the most basic concepts of Article 9 have not changed. Second, you have the chance to get in on the ground floor of a new statute. There are many new wrinkles in the statute, and you will get a chance to see them develop from the beginning.

A few more disclaimers and we can begin. Do not lose sight of the fact that Article 9 is just a model statute; it is not law. Laws, of course, are issued by the individual state legislatures. States can and do enact nonuniform amendments to the Code. A particular state may embrace 95% of the official version of Article 9, and a lawyer who relies on the official version in practicing in that state will, at best, be right only 95% of the time. As a result, the version of Article 9 as enacted in a particular state *must* be consulted before practicing in that state. With that disclaimer, this book will ignore, except in rare instances, particular changes made by the states. We will thus focus on the current official text of Article 9. Article 1 is also relevant as it sets out general guidelines and definitions used throughout the rest of the UCC.

In addition to the text of the UCC, official comments are set out for the provisions. The comments will often help clear up ambiguities in the text, though they should not be understood to override clear textual provisions. The comments are often cited by the courts, as we will see, in their efforts to decipher the relevant statutory provisions. (For a general discussion of the role of the comments, see Note, The Jurisprudence and Judicial Treatment of the Comments to the Uniform Commercial Code, 75 Cornell L. Rev. 962 (1990).) In addition, cross-references and definitional cross-references are given at the end of the comments. Finally, in 1990, the Permanent Editorial Board started issuing new commentaries interpreting provisions of Article 9 in the light of the evolving caselaw. These should prove influential and therefore should be considered in examining the provisions.

SECTION III. CREATING AND PERFECTING SECURITY INTERESTS

The Basic Secured Transaction. Recall that unsecured lending consists of an exchange of money for a promise of repayment. Secured lending adds two steps. First, the debtor must create a security interest in favor of the secured creditor. Second, to enjoy the full benefits of a security interest, the secured creditor must give notice to the public of its interest. Figure 1.1 below sets out the four steps:

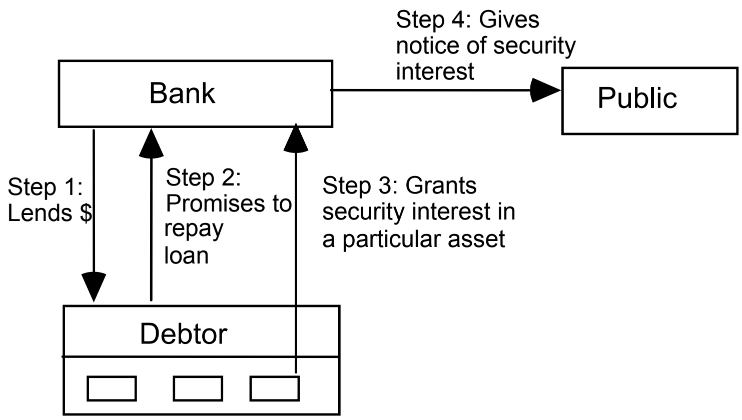

Figure 1.1: Attachment and Perfection of Security Interests

Steps 1 and 2 are the basic steps required to create an unsecured loan. In step 3, the debtor grants the creditor a security interest in some or all of its personal property. In step 4, the newly-secured creditor gives the public notice of its interest. You should not attach any special significance to the order in which the transaction in Figure 1.1 is set out. For the careful lender, step 4, giving notice to the public, will come first, followed by steps 2 and 3, and only then does the debtor get its hands on the cash in step 1. There may be a bit of a delay between giving the notice and the other steps, and we will see why that might be. Nonetheless, for current purposes, think of the transaction as set forth above.

In understanding steps 3 and 4 and what distinguishes a secured creditor from an unsecured creditor, two types of rights are important: property rights and priority rights. Property rights describe the special rights the secured creditor acquires against its debtor. The secured creditor receives property rights against the debtor to short-circuit the collection process faced by an unsecured creditor. The grant of the security interest creates these rights. The second key idea is priority rights. An unsecured creditor competes with other unsecured creditors for the debtor's limited assets and runs the risk that nothing will remain when the creditor goes to collect. In contrast, if the secured creditor gives notice to the public of its security interest, the secured creditor reserves a place in line for its collateral. It creates a priority to those assets.

Attachment and Perfection. To drop down one level of detail, under 9-609 and 9-610 of Article 9 of the UCC, if the debtor defaults, the secured creditor can repossess the property without going to court first (if it can do so without a breach of the peace) and can sell the property and keep the proceeds. These are the key property rights of the secured creditor and they exist as soon as the debtor grants a security interest to the creditor, even if the creditor never gives notice of that interest to the public. The security interest itself is granted pursuant to the provisions of 9-109, 9-201 and 9-203, and the process of granting a security interest is called *attachment*.

Notice matters, though, in an important way. If notice is given—if, in the language of Article 9, the security interest is *perfected*—the secured creditor receives priority rights. These are the rights of one creditor against other creditors. The secured creditor's interest is prior to that of an unsecured creditor, prior to that of a judgment creditor and prior to that of an execution creditor. The secured creditor gets to collect first. In effect, by taking a security interest in the beginning, the secured creditor opts out of the race to the assets that typifies the position of the unsecured creditor. (As we will explore later, though, secured creditors do need to worry about other secured creditors.)

Creating the Security Interest under Article 9. Article 1 of the Uniform Commercial Code contains general definitions and rules of construction applicable in the other articles. 1-201(37) defines "security interest" as "an interest in personal property … which secures payment or performance of an obligation." Article 9 is limited to security interests in personal property, and the definition of security interest is the primary source of this limit. (See also 9-109.) The security interest is an "interest" in property. This definition tells us nothing about the nature of that interest; that will require careful review of Article 9, though as noted, 9-609 and 9-610 will loom large. It is an interest that "secures payment or performance of an obligation." Security interests are inextricably linked to their underlying obligations, though at times the link will be so tight as to make it difficult to separate the security interest and the obligation. (This will arise when a security interest secures a *nonrecourse* obligation.)

Section 9-203 relies on two main methods for creating a security interest: through a written contract or through transfer of possession of the property. Throughout much of the history of secured transactions, the transfer of possession—the *pledge*—was the only effective way of creating a security interest. Security pursuant to a written contract is a relatively recent innovation and even today is not found in all countries. The requirement that the borrower give up possession of the collateral to the secured creditor severely limited the usefulness of the secured transaction. A business that handed over its equipment to a third party would be out of business quickly, as transferring possession of the assets would take them out of their most productive use. Pledging might work for small items held by consumers—as it still does in pawnbroking today—but, at least in its pure form, it was a weak and ineffective device for business.

The Ostensible Ownership Problem. The early law's focus on possession reflected its view that a contrary rule would lead to fraud and deception. For real property, a substantial paper trail of deeds and transfers of ownership existed. The owner of Blackacre would be determined not by reference to who possessed the property but rather by what the public records revealed. In contrast, few, if any, systematic records were kept of ownership of personal property. As a result, possession of personal property gave rise to a permitted inference of ownership of that property. Possession and ownership were treated as one.

Now insert security interests into this system. If the debtor transferred a security interest yet kept possession, possession and ownership were separated. If these "secret liens" were valid, it was no longer prudent to infer ownership from possession. An "ostensible ownership" problem would arise: the debtor would appear to own property, but, in truth, a third party would have an interest in it. The concern that the ostensible ownership problem would lead to widespread fraud led to a simple, bright-line rule: a valid security interest could be created only by transferring possession of the property. No separation of ownership and possession was allowed.

Not really. The purported "solution" to the ostensible ownership problem simply created such a problem and in fact *required* a separation of ownership and possession. When the common law debtor delivered a ring in pledge to the creditor, the debtor still was the owner of the ring. The creditor as the new possessor appeared to own the ring—if we followed out the common law inference of ownership from possession—when in fact the rights in the ring were limited to those specified in the contract between the debtor and the creditor. The pledge system therefore had substantial weaknesses. The requirement of delivery substantially undercut its usefulness, since it took property out of productive uses. Moreover, the rationale for the system—preventing fraud by linking ownership and possession—was internally incoherent.

Section 9-203 still permits security interests to be created by transferring possession, but most are created via contract. In most cases, three requirements must be met. First, there must be a signed agreement between the creditor and the debtor, a security agreement for short. The term "security agreement" is defined in 9-102(a)(73), but it is essentially just a contract that creates a security agreement. Security agreements are often quite lengthy, but at the heart of any security agreement is something usually referred to as the "grant clause." That clause says something like "Debtor hereby grants a security interest in its inventory to Creditor." (The security agreement will often contain an elaborate definition of inventory.) Second, the debtor must have rights in the collateral. This is usually straightforward, as the debtor will grant a security interest in property it owns, but, as always, fringe cases complicate the analysis. Third and finally, the creditor must give "value" to the debtor. "Value" is a defined term, see 1-201(44), but usually just means lending money or entering into a commitment to lend money. Once these three conditions are met, the security interest attaches, unless the parties expressly delay the attachment. See 9-203.

When the security interest has attached, the secured creditor can enforce Article 9's property rights. In the main, these are rights applicable when the debtor defaults. 9-609 and 9-610 are of particular importance. 9-609 allows the secured creditor to repossess the collateral after a default without going to court, so long as the secured creditor can do so without a breach of the peace. Note that this latter limit makes it easy to overstate the difference between secured and unsecured creditors, at least on this dimension. If the debtor is willing to part with the property voluntarily, the unsecured creditor need not obtain a money judgment either, since nothing prevents the debtor from simply paying the unsecured creditor voluntarily, in cash or in other property. If the debtor will not pay voluntarily and wants to block a repossession under 9-609, at least for tangible property, the secured creditor must go to court as well. Once the property is in hand, 9-610 lets the secured creditor dispose of the property to pay off the debt. The disposition must be commercially reasonable, a requirement enforced by penalties under 9-625.

Perfecting the Security Interest. So far we have focused on how property rights are created against the debtor; these rights are the first of the two defining characteristics of secured credit. The second characteristic is the priority right that the secured creditor enjoys against other creditors. A separate process—*perfection*—is necessary to create rights against third parties. In Figure 1.1, this is step 4: the public is notified that a security interest was created in step 3. 9-308 to 9-316 set out Article 9's requirements for perfection.

The basic rule for perfection is set forth in 9-308(a): perfection occurs when the security interest has attached and the steps for perfection set out in 9-310 through 9-316 have been completed. There are many intricacies to these rules, but until recently, the process of perfection has been conceptually quite simple: a secured creditor perfected through filing a financing statement or through taking possession of the property. Revised Article 9 has added taking control of collateral, see 9-314, as a third important approach to perfection. Control represents a natural evolution of the idea of possession. As to filing, filing of what and where? The paper to be filed is called a financing statement, or sometimes a UCC-1. See 9-521.

9-502(a) sets out the contents required in the financing statement: the names of the debtor and the secured creditor, and the statement must indicate the collateral "covered" by the financing statement. The prior version of Article 9 required that the debtor sign the financing statement, but this has been dropped in the hopes of facilitating electronic filing. A signature was just one way—but certainly not the only way—of evidencing that the debtor had authorized the filing of the financing statement. Revised Article 9 continues to insist that the debtor must authorize the filing of the financing statement. See 9-509(a).

The requirement that the financing statement indicate the collateral covered by the financing statement is conceptually quite important. This makes Article 9 a *reified priority system*. Priority is defined with reference to particular property. The secured creditor has priority in inventory or equipment or something else. The secured creditor does not have a general priority over all of the debtor's assets. In fact, this country's laws make it rather difficult to create such a priority. 9-109 excludes many situations from Article 9, and this effectively makes residual state law applicable. As a result, a creditor wishing to take a security interest in all assets must proceed methodically from property type to property type and in so doing invoke Article 9, real estate law and other residual state law.

Filing Location. This tells us *what* the secured creditor must file if that is the method it uses to seek priority. The *where* of filing is given by 9-301 and 9-501 together. 9-301 creates a special choice-of-law rule for Article 9. Note that not only is the priority system reified—tied to particular types of property—it is tied to particular states. You file somewhere in Arkansas or Ohio or whatever state is the relevant state; we do not have a central filing system for the United States as a whole. Consequently, we must sort out which state is the relevant state for filing. 9-301 lays this out. Revised Article 9 departs from the prior statute in an important way. Under the old statute, both the location of the collateral and the location of the debtor were relevant. When collateral had a natural location, that location controlled; otherwise, the location of the debtor controlled. Most goods, such as equipment and inventory, have a natural location. Other goods are usually mobile—most vehicles qualify—and therefore have no natural location. This is true of intangible property as well, such as a receivable or a trademark. For property without a natural location, the location of the debtor controlled. If a debtor granted a security interest in, say, inventory and accounts receivable, the secured creditor would have had to file two financing statements, one for the inventory in its location, and a second for the accounts receivable in the location of the debtor. In contrast, Revised Article 9 focuses instead on the location of the debtor. See 9-301. This should considerably simplify filing financing statements and reduce the number of relevant jurisdictions in complicated transactions.

If the secured creditor has met all of Article 9's requirements, it holds a perfected security interest. That is, the secured creditor has taken all of the steps required by Article 9 to vest rights against third parties. That is *not* to say that the perfected secured creditor always triumphs in a contest with third parties; we can have contests between creditors holding perfected security interests in the same collateral, or between a perfected secured creditor and a levying lien creditor, or between a perfected secured creditor and a purchaser of the collateral. We turn to these issues next.

Section IV. Priority of Security Interests

What does the secured creditor get by being perfected? Before examining this, consider an "Irrelevance Proposition": Secured transactions are irrelevant if the debtor's business does well. It is when the debtor fails and there is a fight over its assets that the relative rights among creditors matter. Three sections, 9-201, 9-317 and 9-322, are of particular relevance. 9-201 establishes our baseline presumption: "[e]xcept 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." 9-317 sets out the rights of secured creditors, unsecured creditors and lien creditors, while 9-322 controls basic disputes among secured creditors.

Start with disputes between secured creditors and non-secured creditors. 9-317(a)(2) states that an unperfected security interest is subordinate to the interest of a lien creditor. "Lien creditor" is defined in 9-102(a)(52); for now, think of a lien creditor as an unsecured creditor that has acquired a lien on the debtor's property through the state law collection process. 9-317 states that the unperfected secured creditor's interest is inferior to that of the lien creditor. This language has always been interpreted to mean—and the official UCC comments to 9-317 make this clear—that a perfected security interest is superior to the rights acquired by a lien creditor. Again, that should be straightforward given the baseline established by 9-201. (As always, there are qualifications to the rule that a perfected secured creditor is superior to a lien creditor, but we'll ignore details for now.)

To be concrete, suppose that on January 1st, Finco lends $10,000 to Corp, unsecured; on February 1st, Bank lends $10,000 to Corp, takes a security interest in collateral held by Corp and files an appropriate financing statement. On March 1st, Finco becomes a lien creditor. Who has priority? Under 9-317, Finco, as a lien creditor, loses to a perfected secured creditor, so Bank wins. This is a straightforward example of a first-in-time priority system: Bank wins because it acquired the first perfected property interest. Change the facts. Bank lends on February 1st as before but files its financing statement on March 2nd. Now, Finco became a lien creditor at the time that Bank was an unperfected secured creditor, and under 9-317(a)(2), Bank loses to Finco.

The Reified Priority System. Before looking at Article 9's priority rules, consider an example that should be clear once we recall that Article 9 implements a reified priority system. On January 1st, Finco lends $10,000 to Corp, takes a security interest in equipment and files an appropriate financing statement. On February 1st, Bank lends $10,000 to Corp, takes a security interest in inventory and files an appropriate financing statement. On March 1st, Creditco lends $10,000 on an unsecured basis. Two weeks later on March 15th the inventory is worth $5,000, the equipment, $15,000, and the debtor has no other assets. Who has priority? (Ignore for now the fact that the inventory on March 15th is almost surely different from the inventory on February 1st, the date Bank created its security interest in inventory. This raises many interesting questions that will be considered when we reach the topic of after-acquired property (see 9-204).)

Start with the basic priority principle for secured credit under Article 9: priority is defined in particular categories of property. Finco acquired special rights in equipment but not in inventory. Bank acquired special rights in inventory but not in equipment. Creditco has no special rights at all. Finco would collect its full $10,000 from the equipment worth $15,000. The balance of $5,000 would go first to junior secured creditors in the equipment, but there are none; next, to lien creditors, none again; and, finally, to unsecured creditors. This means Creditco, but it may mean Bank as well. It in fact does. As the only secured creditor in inventory, Bank gets first crack at it. Bank collects the $5,000 from the inventory and then is owed $5,000. Bank is an unsecured creditor for this amount. It has exhausted its special rights against the inventory and it has no special rights in the equipment. Creditco and Bank are on par as to the final $5,000. In bankruptcy, they would share this pro rata—see Bankruptcy Code ("BC") 726(b)—meaning here that with Bank owed $5,000 and Creditco owed $10,000 giving total debts of $15,000, Creditco would receive 10,000/15,000 or 2/3 of the $5,000 or $3,333 and Bank would receive 5,000/15,000 or 1/3 of the $5,000 or $1,666. Outside bankruptcy, the first unsecured creditor to the assets wins, so the unsecured creditors race to the assets. This will lead to wide variations in individual collections, limited by the fact that creditors can push the debtor into bankruptcy involuntarily and thereby opt into the pro-rata distribution rules.

To recap, Article 9's principle that priority is defined by particular assets resolves cases in which there are no overlapping security interests. When security interests do overlap, the first-in-time rule establishes priority. In the prior example, assume that Bank took a security interest in equipment in addition to the security interest in inventory. Nothing in Article 9 would prevent this, as Article 9 says nothing about how much security a secured creditor can take. Now we do have a conflict among secured creditors. Both Finco and Bank claim a perfected security interest in the equipment. Recall what was said before: having a perfected security interest means that the secured creditor has a prior position against unsecured creditors. But as between secured creditors holding a perfected security interest in the same asset, we need a different rule.

Section 9-322 gives the basic rule. This section covers a number of situations, but 9-322(a) establishes the basic rule for two ordinary secured creditors claiming a security interest in the same collateral. On January 1st, Finco lends $10,000 to Corp, takes a security interest in equipment and files an appropriate financing statement. On February 1st, Bank lends $10,000 to Corp, takes a security interest in the same equipment and files an appropriate financing statement. 9-322(a)(1) provides that the earlier of first to file or perfect wins. Focusing on the earlier of first to file or perfect is necessary given that Article 9 often allows secured creditors to perfect through filing or through taking possession. In this example, both creditors perfected through filing and 9-322(a)(1)'s rule reduces to a very simple rule: the first to file wins. Finco therefore has priority.

Notwithstanding the apparent simplicity of this rule, it is easy to lose sight of what it means. Suppose that on January 1st, Finco lends $10,000 to Corp, takes a security interest in equipment but files no financing statement. On February 1st, Bank lends $10,000 to Corp, takes a security interest in the same equipment and files an appropriate financing statement. On February 2nd, Finco files an appropriate financing statement. Who has priority? First to file wins. Even though Finco lent money and took a security interest before Bank did, it did not make that interest public. By failing to file, Finco ran the risk—realized here—that an otherwise later secured creditor will file first. When Bank checked the public records before making its loan, it found nothing to put Bank on notice of Finco's interest.

Finco lent first and filed second and therefore was junior; so goes the first-to-file rule. This rule also means that a creditor that files first and lends second takes priority. On January 1st, Finco files a financing statement signed by Corp for collateral described as equipment but lends no money. On February 1st, Bank lends $10,000 to Corp, takes a security interest in equipment and files an appropriate financing statement. On March 1st, Finco lends $10,000 to Corp and takes a security interest in equipment. Who has priority? The first to file wins. Finco filed first and this suffices to reserve priority for Finco for any later lending and grant of a security interest in equipment. Bank was put on notice of Finco's reserved place in line by the financing statement. Bank took a big risk by lending to Corp without reaching some sort of agreement with Finco about the pending financing statement.

The basic first-to-file rule also forms the basis for Article 9's rule regarding *future advances*. On January 1st, Finco lends $1,000 to Corp, takes a security interest in equipment and files an appropriate financing statement. On February 1st, Bank lends $10,000 to Corp, takes a security interest in the same equipment and files an appropriate financing statement. On March 1st, Finco takes a second security interest in the equipment and lends an additional $9,000. Who has priority? Again, the first secured creditor to file wins. Finco has priority for both loans. The second loan is in the nature of a future advance, a loan made after the initial loan. (If one wanted to be technical, the second loan might not be considered a future advance as it was made pursuant to a different contract.) The future (or subsequent) advance question created problems for early secured transactions law, but Article 9's rule is clear and follows directly from the basic first-in-time principle. See 9-204, 9-323. Article 9 refuses to embrace this rule in full, though, as a different rule applies between a secured creditor and a lien creditor or some third-party purchasers. See 9-323.

Perfection through Possession. Whether the first-to-file system is a good system is debatable, but, with some exceptions, it is Article 9's system. One important exception is perfection through possession; in Revised Article 9, control has become an important method of perfecting. As noted, in early secured transactions law, possession was the only way to create a lien enforceable against third parties. For many kinds of property, possession remains an acceptable means for perfecting; for some, it is the exclusive means. This creates some complexities for determining priority. On January 1st, Finco lends Corp $10,000, takes a security interest in a laptop computer and perfects by taking possession. On February 1st, Bank lends $10,000 to Corp, takes a security interest in the computer and files an appropriate financing statement. On March 1st, Finco files a financing statement for the computer and gives up possession to Corp. Who has priority? If the simple first-to-file rule applied, Bank would hold priority. 9-322(a)(1) creates a richer rule: the earlier of first to file or perfect wins, so long as there was never a time at which the secured party had neither filed nor perfected. The date of the first filing is February 1st, the date Bank filed. The date of the first perfection is January 1st, the date Finco first satisfied all of the requirements for perfection. As Finco filed a financing statement before giving up possession of the laptop, the date it perfected through possession controls. Finco therefore has priority.

SECTION V. CHANGES AND STALE INFORMATION

Businesses are dynamic; they change locations, they change names. Most businesses are in the business of buying and selling something. When an asset is sold, something is given in return for it. It may be cash or a check or it may be a promise to pay at a later date. The same is true when an asset is purchased. The buyer gives up something of value to get the new asset. We must consider how we overlay our system of security interests and record public notice on fundamentally changing businesses. The nature of the limited notice required of the secured creditor gives rise to complications when a key condition that existed at the time of the original notice changes. To put the point differently, change makes the information on file stale.

Burdens of Monitoring and Inquiry. A record notice system takes a snapshot at a particular point in time. As part of a notice system, we have to allocate the consequences of this stale information. How we allocate these consequences in turn creates incentives either for a secured creditor to update the filing or for a prospective secured creditor to verify that the record information is current. In very general terms, burdens of monitoring or inquiry will be imposed. If the prior secured creditor runs the risk of losing that position through a change, it will have to monitor the debtor to detect possible changes and update the public records. If the prior security interest and the status it has survives the change, the public record deceives a subsequent secured creditor. It must make costly inquiries and this will necessarily raise the price of credit. The goal of Article 9 should be to minimize the sum of the costs of monitoring and the costs of inquiry resulting from how the consequences of change are allocated.

Consider an example. On January 1st, Bank lends $10,000 to Corp, takes a security interest in equipment and files an appropriate financing statement. The filing will have the debtor's name on it and will be indexed under that name. See 9-519(c)(1). That means that anyone wishing to determine whether there are financing statements pending against Corp will submit a request in the filing office under that name. On February 1st, Corp changes its name to Company. The next day, Finco approaches Company to make a loan and conducts a search of the public records to determine whether the firm has prior secured creditors.

Consider the range of possible rules. We might impose the risk of stale information on the secured creditor who has already filed. Under that rule, Finco can check the records under the debtor's current name and be confident of priority if no statements are found. Such a rule would force Bank to watch Corp closely to ensure that it did not change its name or to charge an interest rate commensurate with the risk that it might. Alternatively, we might impose the risk of stale information on the later secured creditor. Under that rule, Finco has a burden of inquiry: it must find out what prior names Company has had. Searching under the name Company alone will not protect Finco, if, as happened here, another creditor filed against a prior name.

Do not think for a moment that the debtor will be able to take advantage of the initial secured creditor. There are no new tricks here. Instead, the debtor's inability to commit to the first secured creditor that no name change will ensue reduces the scope of real freedom available to the debtor. The parties cannot put into place a contract that ensures that the debtor will take the step in their joint interest, but instead must assume that the debtor will change its name, to the detriment of the first secured creditor, if it is in the debtor's interest to do so.

Knowledge-Based Rules. We could impose a more tailored rule. We could say that if the original secured creditor learns of the name change, it has a duty to update the files, and in the absence of so doing, it bears the risk of stale information. And, you might think that this rule would track the context in which name changes would occur. Many name changes are driven by the needs of corporate image. US Steel's business changes and it becomes USX. I don't know what that means, but it doesn't suggest molten steel, and that's the point. The public's nickname for Allegheny Airlines is "Agony Airlines"—which is hardly a selling point—so it becomes USAir. There is good reason to think that the secured creditor may be told of this kind of name change—indeed, the whole world will learn of the change. Nonetheless, other name changes may occur precisely to confuse and deceive. The initial secured creditor will not be told of these changes, unless it is in cahoots with the debtor. The tailored rule just suggested would track what the initial secured creditor would likely know.

But it is far from obvious that this rule is an improvement over the prior rules. When Finco considers whether to make a loan, it knows that checking under the current name alone puts it at risk. Company may have changed its name recently, and if the first-filed secured creditor did not know of the change, it will retain priority. Also, the one thing we know about a knowledge-based rule is that it will lead to litigation. After the fact, much will turn on whether the later secured creditor can make a showing that the first-filed secured creditor knew of the name change. In this situation and in others like it, the legal rules have to allocate the risk of stale information. Doing so is unavoidable. In this particular case, Article 9 resolves this question by protecting the initial secured creditor for all collateral held by the debtor prior to the name change and for any additional collateral acquired within four months thereafter. See 9-507(c).

Selling and Buying Property. A second example should confirm the pervasive problem of changed conditions in a system of record notice. On January 1st, Bank lends $10,000 to Corp, takes a security interest in "computers, now and hereafter owned by Corp" and files a financing statement listing the collateral as "computers." On February 1st, Corp decides to get a new computer. It buys a new computer from Retailer for cash and swaps its old computer for a copier owned by Company. When all is said and done, Corp owns a new computer and the copying machine while Company owns Corp's old computer.

This is a relatively straightforward transaction; the only mildly unusual aspect to it is that the old computer was exchanged for other equipment rather than sold for cash. But this simple situation raises a number of important questions relating to the interaction between changed conditions and secured creditors. Focus on (1) the new computer in Corp's hands; (2) the old computer, now in Company's hands; and (3) the copier now held by Corp. Corp's new computer is *after-acquired property*. As the name suggests, it is property acquired by the debtor after the date of the initial grant of a security interest. 9-204 allows a security interest to cover after-acquired property. The language "now and hereafter" is expressly temporal and is a common way of granting a security interest in after-acquired property. Bank therefore has a security interest in Corp's new computer. Whether it is perfected depends on whether the language "computers" in the financing statement suffices for both property owned at the time the financing statement is filed and that acquired later. It does. The purpose of the financing statement is notice; once on notice, an interested party should inquire about the full extent of the prior interest. That reasoning, of course, isn't wholly consistent with Article 9, though, as it would suggest we could dispense with the description requirement in its entirety. We will pursue this issue later; for now, note the relationship between the range of inquiries that will be made and the information contained in the financing statement. Bank therefore holds a perfected security interest in the new computer.

Next consider the old computer now owned by Company. Bank took a security interest in it to make sure that value would be available to it should Corp get in financial trouble. We once again face an allocation problem, or two allocation problems actually. Consider first the inquiries Company should make as a prospective purchaser. If Bank's perfected security interest survives the sale, Company will risk loss of the computer if Corp defaults on its loan from Bank. Under that rule, Company will either have to search the public records or adjust the purchase price. Note that Company will almost surely ask Corp to represent and warrant that there are no outstanding liens against the computer, but if Corp breaches that promise, Company will hold an unsecured claim for damages. On the other hand, if the security interest is cut-off by the sale, Bank once again faces a monitoring burden. As we will see, Article 9 draws a fairly predictable line. It would be virtually intolerable in retail transactions to expect the purchaser to determine whether the seller had granted a security interest in its inventory. Imagine going into a store such as Sears to buy a washing machine and having to inquire about Sears' capital structure. In rough terms, sales from inventory are free of a security interest. See 9-320(a). The secured creditor clearly should understand that Sears is going to sell the washing machines. But for many other sales, the sale was not contemplated in advance, and the security interest does survive the sale. This would be true of Corp's sale of the computer, unless Bank consented to the sale. See 9-315(a)(1). Bank's financing statement will also remain effective. See 9-507(a).

The old computer leads to a second allocation problem. To see this, assume that on March 1st, Finco approaches Company to make a loan. Finco will search the records for financing statements filed against Company. Bank's statement against Corp will not turn up. If Bank's prior perfected security interest in the computer continues notwithstanding the sale, Finco will either have to inquire into Company's source of title for its equipment or adjust its charges accordingly. If the security interest does not continue, Bank will once again be forced to monitor for possible sales or charge higher prices. Again, we must allocate the burden of inquiry and the burden of monitoring. As noted above, as to the computer, which was equipment in Corp's hands, Bank's perfected security survives the sale. Finco must adjust its behavior accordingly.

We still have not discussed the copier. Recall that Corp swapped its old computer for the copier. What rights, if any, does Bank have to the copier? Bank's security interest and financing statements extended only to computers. This covered the computers originally owned by Corp and those acquired later. But neither the security interest nor the financing statement covered the copier. Notwithstanding this, Bank may hold a perfected security interest in the copier. Article 9 confers rights in property received in exchange for collateral. The property received in exchange is called *proceeds*, see 9-102(a)(64), and the secured creditor automatically receives a security interest in identifiable proceeds, unless it waives it. See 9-203(f) and 9-315(a)(2). Bank will therefore have a security interest in the copier.

Whether it is perfected turns on 9-315(d) and that need not detain us here, except to note that Bank may be perfected as to the copier, even though it is *not* listed as collateral in the financing statement. As should be clear, this once again places great stress on Article 9's system of public notice. Finco approaches Corp to make a loan. It finds Bank's financing statement listing its collateral as computers. Can Finco lend safely against the copier? Once again, it may need to inquire into how Corp acquired the copier.

SECTION VI. MISCELLANEOUS MATTERS

We have just seen the heart of secured transactions in personal property under Article 9. Much detail has been omitted, so this is really no more than a sketch of the major issues and a few of the ways that Article 9 addresses them. There are three other issues that are worth mentioning before moving on to our detailed inquiry into secured transactions.

Purchase Money Security Interests. Consider an example. On January 1st, Bank lends $10,000 to Corp, takes a security interest in "computers, now and hereafter owned by Corp" and files an appropriate financing statement. On February 1st, Corp decides to add another computer. Corp approaches Retailer to buy the new computer. Retailer is willing to finance the purchase price but only if it receives a first priority interest in the new computer. Given the earlier-filed financing statement in favor of Bank, in the absence of special provisions in Article 9, Retailer would have to negotiate a subordination agreement with Bank. A subordination agreement is a contract between two creditors pursuant to which one creditor agrees to accept a position junior to that of the other creditor. Unsurprisingly, nothing in Article 9 bars such agreements. See 9-339.

Negotiating such an agreement may be sufficiently costly so as to make financing by Retailer impossible. If one thought that such agreements would be given as a matter of course but would not be reached because of the cost, a better outcome could be reached if Article 9 simply allowed the financing seller to take a first position for the collateral it sells. Article 9 does just this through the notion of a *purchase money security interest.* A seller who finances its sale, or another creditor whose extension of credit can be traced directly to an acquisition, achieves a first priority for the collateral sold, if it complies with certain statutory requirements. See 9-103 and 9-324.

Priorities in Paper Collateral. As is true of all statutes, Article 9 does not exist in a vacuum. At various points, Article 9's priority system reflects concerns central to other areas of the law. This is true of the system of priorities in paper collateral—instruments, such as checks, are the best example of this—where the notion of negotiability matters a great deal. Without considering all of the details of this notion—currently embodied in Article 3 of the UCC, covering commercial paper—the key idea is that transfer of possession (often coupled with an endorsement) of a promise to pay money vests certain rights in the recipient. Possession of this promise to pay carries even greater weight than possession usually does for personal property. Article 9 embraces this idea by making perfection through filing an inferior means of perfecting for paper collateral. A secured creditor that perfects through filing can lose priority to another who perfects through taking possession. See 9-330, 9-331.

Interfacing Article 9 with Other Law. The line between Article 9 and issues of negotiability is only one instance in which we must sort out the relative roles of two otherwise distinct bodies of law. The same problem arises when the line blurs between personal property and real property. This is the law of *fixtures* and is covered by 9-334 and 9-102(a)(41). Another context is given by interests in property other than security interests. Security interests arise through consent. In contrast, state and federal law may establish nonconsensual statutory liens that arise out of some relationship between the debtor and a third party. For example, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, codified at 42 USC 9601-57, gives the federal government a lien on damaged real property cleaned up by the government. As always, it matters a great deal whether that lien is junior to or superior to a security interest created in the property.

As to state law liens, Article 9 addresses these issues at various points—9-333—and the other law in question may do so as well. As to liens under federal law, Article 9 could just subordinate consensual security interests to those liens, but otherwise, as state law, it cannot address the question of the relative priority of federal liens and Article 9 security interests. The relevant federal statute must be consulted. The most important of these relating to personal property are federal tax liens and liens in favor of the Pension Benefit Guaranty Corporation. Finally, and probably most importantly, the rights of a secured creditor cannot be fully understood without a firm grasp of the Bankruptcy Code. Security matters most when the firm fails; many failing firms resolve the rights against them in bankruptcy court. How the Bankruptcy Code implements the rights created under Article 9 is therefore of substantial importance in understanding those rights.