# Security Interests in Personal Property

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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 Ford Credit, Ford'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 Ford Credit, 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. The focus of this book reflects the scope of the law applicable to secured transactions, as 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. The rules for this process are often set forth as part of the state's civil procedure code.

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.

Between 1990 and 1994, GMD was involved in a toll road construction program sponsored by the Government of Mexico. In order to elicit private financing, the Mexican Government granted concessions to companies who would build and operate the system of toll roads. GMD was both an investor in the concessionaries and among the construction companies

hired by the concessionaries to build the toll roads. Problems in the Mexican economy resulted in severe losses for the concessionaries, who were therefore unable to pay contractors like GMD. In response to these problems, in 1997, the Mexican Government announced the Toll Road Rescue Program, under which it would issue guaranteed notes (Toll Road Notes) to the concessionaries, in exchange for their ceding to the Government ownership of the toll roads. The Toll Road Notes were to be used to pay the bank debt of the concessionaries, and also to pay outstanding receivables held by GMD and other contractors for services rendered to the concessionaries (Toll Road Receivables). In the fall of 1997, GMD announced that it expected to receive approximately $309 million of Toll Road Notes under the program.

Because of the downturn in the Mexican economy and the related difficulties in the toll road program, by mid-1997 GMD was in serious financial trouble. In addition to the Notes, GMD owed other debts of about $450 million. GMD's 1997 Form 20-F, which was filed with the Securities and Exchange Commission on June 30, 1997, stated that GMD's current liabilities exceeded its current assets and that there was "substantial doubt" whether it could continue as a going concern. As a result of these financial problems, neither GMD nor its subsidiaries (who had guaranteed payment) made the August 1997 interest payment on the Notes.

Between August and December 1997, GMD attempted to negotiate a restructuring of its debt with its creditors. On August 26, Reuters reported that GMD was negotiating with the Mexican banks to reduce its $256 million bank debt, and that it planned to deal with this liability before negotiating with the investors owning the Notes. On October 28, GMD publicly announced that it would place in trust its right to receive $17 million of Toll Road Notes, to cover employee compensation payments, and that it had transferred its right to receive $100 million of Toll Road Notes to the Mexican Government (apparently to pay back taxes). GMD also negotiated with the holders of the Notes (including respondents) to restructure that debt, but by December these negotiations had failed.

On December 11, respondents accelerated the principal amount of their Notes, and, on December 12, filed suit for the amount due in the United States District Court for the Southern District of New York (petitioners had consented to personal jurisdiction in that forum). The complaint alleged that "GMD is at risk of insolvency, if not insolvent already"; that GMD was dissipating its most significant asset, the Toll Road Notes, and was preferring its Mexican creditors by its planned allocation of Toll Road Notes to the payment of their claims, and by its transfer to them of Toll

Road Receivables; and that these actions would "frustrate any judgment" respondents could obtain. Respondents sought breach-of-contract damages of $80.9 million, and requested a preliminary injunction restraining petitioners from transferring the Toll Road Notes or Receivables. On that same day, the District Court entered a temporary restraining order preventing petitioners from transferring their right to receive the Toll Road Notes.

On December 23, the District Court entered an order in which it found that "GMD is at risk of insolvency if not already insolvent"; that the Toll Road Notes were GMD's "only substantial asset"; that GMD planned to use the Toll Road Notes "to satisfy its Mexican creditors to the exclusion of [respondents] and other holders of the Notes"; that "[i]n light of [petitioners'] financial condition and dissipation of assets, any judgment [respondents] obtain in this action will be frustrated"; that respondents had demonstrated irreparable injury; and that it was "almost certain" that respondents would succeed on the merits of their claim. It preliminarily enjoined petitioners "from dissipating, disbursing, transferring, conveying, encumbering or otherwise distributing or affecting any [petitioner's] right to, interest in, title to or right to receive or retain, any of the [Toll Road Notes]." The court ordered respondents to post a $50,000 bond.

The Second Circuit affirmed. 143 F.3d 688 (1998). * * *

III

We turn, then, to the merits question whether the District Court had authority to issue the preliminary injunction in this case pursuant to Federal Rule of Civil Procedure 65.[3] The Judiciary Act of 1789 conferred on the federal courts jurisdiction over "all suits ... in equity." 1 Stat. 78. We have long held that "[t]he 'jurisdiction' thus conferred ... is an authority to administer in equity suits the principles of the system of judicial remedies which had been devised and was being administered by the English Court of Chancery at the time of the separation of the two countries." *Atlas Life Ins. Co. v. W.I. Southern, Inc.*, 306 U.S. 563 (1939). * * * We must ask, therefore, whether the relief respondents requested here was traditionally accorded by courts of equity.

[3] Although this is a diversity case, respondents' complaint sought the injunction pursuant to Rule 65, and the Second Circuit's decision was based on that rule and on federal equity principles. Petitioners argue for the first time before this Court that under *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), the availability of this injunction under Rule 65 should be determined by the law of the forum State (in this case New York). Because this argument was neither raised nor considered below, we decline to consider it.

A

Respondents do not even argue this point. The United States as *amicus curiae*, however, contends that the preliminary injunction issued in this case is analogous to the relief obtained in the equitable action known as a "creditor's bill." This remedy was used (among other purposes) to permit a judgment creditor to discover the debtor's assets, to reach equitable interests not subject to execution at law, and to set aside fraudulent conveyances. It was well established, however, that, as a general rule, a creditor's bill could be brought only by a creditor who had already obtained a judgment establishing the debt. See, e.g., *Pusey & Jones Co. v. Hanssen*, 261 U.S. 491, 497 (1923); *Hollins v. Brierfield Coal & Iron Co.*, 150 U.S. 371, 378-379 (1893). The rule requiring a judgment was a product, not just of the procedural requirement that remedies at law had to be exhausted before equitable remedies could be pursued, but also of the substantive rule that a general creditor (one without a judgment) had no cognizable interest, either at law or in equity, in the property of his debtor, and therefore could not interfere with the debtor's use of that property. * * *

Joseph Story's famous treatise reflects what we consider the proper rule, both with regard to the general role of equity in our "government of laws, not of men," and with regard to its application in the very case before us:

> Mr. Justice Blackstone has taken considerable pains to refute this doctrine. "It is said," he remarks, "that it is the business of a Court of Equity, in England, to abate the rigor of the common law. But no such power is contended for. Hard was the case of bond creditors, whose debtor devised away his real estate.... But a Court of Equity can give no relief...." And illustrations of the same character may be found in every state of the Union.... In many [States], if not in all, a debtor may prefer one creditor to another, in discharging his debts, whose assets are wholly insufficient to pay all the debts.

1 Commentaries on Equity Jurisprudence § 12, pp. 14-15 (1836).

We do not question the proposition that equity is flexible; but in the federal system, at least, that flexibility is confined within the broad boundaries of traditional equitable relief. To accord a type of relief that has never been available before—and especially (as here) a type of relief that has been specifically disclaimed by longstanding judicial precedent—is to invoke a "default rule," not of flexibility but of omnipotence. When there are indeed new conditions that might call for a wrenching departure from past practice, Congress is in a much better position than we both to perceive them

and to design the appropriate remedy. Despite the dissent's allusion to the "increasing complexities of modern business relations," and to the bygone "age of slow-moving capital and comparatively immobile wealth," we suspect there is absolutely nothing new about debtors' trying to avoid paying their debts, or seeking to favor some creditors over others—or even about their seeking to achieve these ends through "sophisticated ... strategies." The law of fraudulent conveyances and bankruptcy was developed to prevent such conduct; an equitable power to restrict a debtor's use of his unencumbered property before judgment was not. * * *

C

As further support for the proposition that the relief accorded here was unknown to traditional equity practice, it is instructive that the English Court of Chancery, from which the First Congress borrowed in conferring equitable powers on the federal courts, did not provide an injunctive remedy such as this until 1975. In that year, the Court of Appeal decided *Mareva Compania Naviera S.A. v. International Bulkcarriers S.A.*, 2 Lloyd's Rep. 509. *Mareva*, although acknowledging that the prior case of Lister & Co. v. Stubbs, [1890] 45 Ch. D. 1 (C.A.), said that a court has no power to protect a creditor before he gets judgment, relied on a statute giving courts the authority to grant an interlocutory injunction "'in all cases in which it shall appear to the court to be just or convenient,'" 2 Lloyd's Rep., at 510 (quoting Judicature Act of 1925, Law Reports 1925(2), 15 & 16 Geo. V, ch. 49, § 45). It held (in the words of Lord Denning) that "[i]f it appears that the debt is due and owing—and there is a danger that the debtor may dispose of his assets so as to defeat it before judgment—the Court has jurisdiction in a proper case to grant an interlocutory judgment so as to prevent him *[sic]* disposing of those assets." 2 Lloyd's Rep., at 510. The *Mareva* injunction has now been confirmed by statute. See Supreme Court Act of 1981, § 37, 11 Halsbury's Statutes 966, 1001 (4th ed. 1985). * * *

The parties debate whether *Mareva* was based on statutory authority or on inherent equitable power. Regardless of the answer to this question, it is indisputable that the English courts of equity did not actually *exercise* this power until 1975, and that federal courts in this country have traditionally applied the principle that courts of equity will not, as a general matter, interfere with the debtor's disposition of his property at the instance of a nonjudgment creditor. We think it incompatible with our traditionally cautious approach to equitable powers, which leaves any substantial expansion of past practice to Congress, to decree the elimination of this significant protection for debtors.

IV

The parties and *amici* discuss various arguments for and against creating the preliminary injunctive remedy at issue in this case. * * * The requirement that the creditor obtain a prior judgment is a fundamental protection in debtor-creditor law—rendered all the more important in our federal system by the debtor's right to a jury trial on the legal claim. There are other factors which likewise give us pause: The remedy sought here could render Federal Rule of Civil Procedure 64, which authorizes use of state prejudgment remedies, a virtual irrelevance. Why go through the trouble of complying with local attachment and garnishment statutes when this all-purpose prejudgment injunction is available? More importantly, by adding, through judicial fiat, a new and powerful weapon to the creditor's arsenal, the new rule could radically alter the balance between debtor's and creditor's rights which has been developed over centuries through many laws—including those relating to bankruptcy, fraudulent conveyances, and preferences. Because any rational creditor would want to protect his investment, such a remedy might induce creditors to engage in a "race to the courthouse" in cases involving insolvent or near-insolvent debtors, which might prove financially fatal to the struggling debtor. * * * It is significant that, in England, use of the *Mareva* injunction has expanded rapidly. * * *

We do not decide which side has the better of these arguments. We set them forth only to demonstrate that resolving them in this forum is incompatible with the democratic and self-deprecating judgment we have long since made: that the equitable powers conferred by the Judiciary Act of 1789 did not include the power to create remedies previously unknown to equity jurisprudence. Even when sitting as a court in equity, we have no authority to craft a "nuclear weapon" of the law like the one advocated here. Joseph Story made the point many years ago:

> If, indeed, a Court of Equity in England did possess the unbounded jurisdiction, which has been thus generally ascribed to it, of correcting, controlling, moderating, and even superceding the law, and of enforcing all the rights, as well as the charities, arising from natural law and justice, and of freeing itself from all regard to former rules and precedents, it would be the most gigantic in its sway, and the most formidable instrument of arbitrary power, that could well be devised. It would literally place the whole rights and property of the community under the arbitrary will of the Judge, acting, if you please, *arbitrio boni judicis*, and it may be, *ex aequo et bono*, according to his own notions and conscience; but still acting with a despotic and sovereign authority.

> A Court of Chancery might then well deserve the spirited rebuke of Seldon; "For law we have a measure, and know what to trust to—Equity is according to the conscience of him, that is Chancellor; and as that is larger, or narrower, so is Equity. Tis all one, as if they should make the standard for the measure the Chancellor's foot. What an uncertain measure would this be? One Chancellor has a long foot; another a short foot; a third an indifferent foot. It is the same thing with the Chancellor's conscience."

1 Commentaries on Equity Jurisprudence § 19, at 21.

The debate concerning this formidable power over debtors should be conducted and resolved where such issues belong in our democracy: in the Congress.

* * *

Because such a remedy was historically unavailable from a court of equity, we hold that the District Court had no authority to issue a preliminary injunction preventing petitioners from disposing of their assets pending adjudication of respondents' contract claim for money damages. We reverse the judgment of the Second Circuit and remand the case for further proceedings consistent with this opinion.

It is so ordered.

■ Justice Ginsburg, with whom Justice Stevens, Justice Souter, and Justice Breyer join, dissenting.

I

* * * The Court nevertheless disapproves the provisional relief ordered by the District Court, holding that a preliminary injunction freezing assets is beyond the equitable authority of the federal courts. I would not so disarm the district courts. As I comprehend the courts' authority, injunctions of this kind, entered in the circumstances presented here, are within federal equity jurisdiction. Satisfied that the injunction issued in this case meets the exacting standards for preliminary equitable relief, I would affirm the judgment of the Second Circuit.

II

The Judiciary Act of 1789 gave the lower federal courts jurisdiction over "all suits ... in equity." § 11, 1 Stat. 78. We have consistently interpreted this jurisdictional grant to confer on the district courts "authority to administer ... the principles of the system of judicial remedies which had been devised

and was being administered" by the English High Court of Chancery at the time of the founding. *Atlas Life Ins. Co. v. W.I. Southern, Inc.*, 306 U.S. 563, 568 (1939).

As I see it, the preliminary injunction ordered by the District Court was consistent with these principles. * * * The District Court acted in this case in careful accord with these prescriptions, issuing the preliminary injunction only upon well-supported findings that Alliance had "[no] adequate remedy at law," would be "frustrated" in its ability to recover a judgment absent interim injunctive relief, and was "almost certain" to prevail on the merits. The Court holds the District Court's preliminary freeze order impermissible principally because injunctions of this kind were not "traditionally accorded by courts of equity" at the time the Constitution was adopted. In my view, the Court relies on an unjustifiably static conception of equity jurisdiction. From the beginning, we have defined the scope of federal equity in relation to the *principles* of equity existing at the separation of this country from England, see, e.g., *Payne v. Hook*, 7 Wall. 425, 430 (1869), we have never limited federal equity jurisdiction to the specific practices and remedies of the pre-Revolutionary Chancellor.

Since our earliest cases, we have valued the adaptable character of federal equitable power. We have also recognized that equity must evolve over time, "in order to meet the requirements of every case, and to satisfy the needs of a progressive social condition in which new primary rights and duties are constantly arising and new kinds of wrongs are constantly committed." *Union Pacific R. Co. v. Chicago, R.I. & P.R. Co.*, 163 U.S. 564, 601 (1896). * * * On this understanding of equity's character, we have upheld diverse injunctions that would have been beyond the contemplation of the eighteenth century Chancellor.

Compared to many contemporary adaptations of equitable remedies, the preliminary injunction Alliance sought in this case was a modest measure. In operation, moreover, the preliminary injunction to freeze assets *pendente lite* may be a less heavy-handed remedy than prejudgment attachment, which deprives the defendant of possession and use of the seized property. Taking account of the office of equity, the facts of this case, and the moderate, status quo preserving provisional remedy, I am persuaded that the District Court acted appropriately.

I do not question that equity courts traditionally have not issued preliminary injunctions stopping a party sued for an unsecured debt from disposing of assets pending adjudication. (As the Court recognizes, however, the historical availability of prejudgment freeze injunctions in the context of

creditors' bills remains cloudy.) But it is one thing to recognize that equity courts typically did not provide this relief, quite another to conclude that, therefore, the remedy was beyond equity's capacity. I would not draw such a conclusion.

Chancery may have refused to issue injunctions of this sort simply because they were not needed to secure a just result in an age of slow-moving capital and comparatively immobile wealth. By turning away cases that the law courts could deal with adequately, the Chancellor acted to reduce the tension inevitable when justice was divided between two discrete systems. But as the facts of this case so plainly show, for creditors situated as Alliance is, the remedy at law is worthless absent the provisional relief in equity's arsenal. Moreover, increasingly sophisticated foreign-haven judgment proofing strategies, coupled with technology that permits the nearly instantaneous transfer of assets abroad, suggests that defendants may succeed in avoiding meritorious claims in ways unimaginable before the merger of law and equity. I am not ready to say a responsible Chancellor today would deny Alliance relief on the ground that prior case law is unsupportive.

The development of *Mareva* injunctions in England after 1975 supports the view of the lower courts in this case, a view to which I adhere. As the Court observes, preliminary asset-freeze injunctions have been available in English courts since the 1975 Court of Appeal decision in *Mareva Compania Naviera S.A. v. International Bulkcarriers S.A.*, 2 Lloyd's Rep. 509. Although the cases reveal some uncertainty regarding *Mareva's* jurisdictional basis, the better-reasoned and more recent decisions ground *Mareva* in equity's traditional power to remedy the "abuse" of legal process by defendants and the "injustice" that would result from defendants "making themselves judgment-proof" by disposing of their assets during the pendency of litigation. *Iraqi Ministry of Defence v. Arcepey Shipping Co.*, 1 All E.R. 480, 484-487 (1979) (internal citations omitted). That grounding, in my judgment, is secure.

III

A

The Court worries that permitting preliminary injunctions to freeze assets would allow creditors, '"on a mere statement of belief that the defendant can easily make away with or transport his money or goods, [to] impose an injunction on him, indefinite in duration, disabling him to use so much of his funds or property as the court deems necessary for security or compliance with its possible decree."' Ante (quoting *De Beers Consol. Mines, Ltd. v.*

*United States*, 325 U.S. 212, 222 (1945)). Given the strong showings a creditor would be required to make to gain the provisional remedy, and the safeguards on which the debtor could insist, I agree with the Second Circuit "that this 'parade of horribles' [would] not come to pass." 143 F.3d 688, 696 (1998).

Under standards governing preliminary injunctive relief generally, a plaintiff must show a likelihood of success on the merits and irreparable injury in the absence of an injunction. Plaintiffs with questionable claims would not meet the likelihood of success criterion. The irreparable injury requirement would not be met by unsubstantiated allegations that a defendant may dissipate assets. As the Court of Appeals recognized, provisional freeze orders would be appropriate in damages actions only upon a finding that, without the freeze, "the movant would be unable to collect [a money] judgment." 143 F.3d, at 697. The preliminary asset-freeze order, in short, would rank and operate as an extraordinary remedy.

Federal Rule of Civil Procedure 65(c), moreover, requires a preliminary injunction applicant to post a bond "in such sum as the court deems proper, for the payment of such costs and damages as may be incurred or suffered by any party who is found to have been wrongfully enjoined." As an essential condition for a preliminary freeze order, a district court could demand sufficient security to ensure a remedy for wrongly enjoined defendants. Furthermore, it would be incumbent on a district court to "match the scope of its injunction to the most probable size of the likely judgment," thereby sparing the defendant from undue hardship. See *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 199 (C.A.3 1990).

The protections in place guard against any routine or arbitrary imposition of a preliminary freeze order designed to stop the dissipation of assets that would render a court's judgment worthless. The case we face should be paradigmatic. There was no question that GMD's debt to Alliance was due and owing. And the short span—less than four months—between preliminary injunction and summary judgment shows that the temporary restraint on GMD did not linger beyond the time necessary for a fair and final adjudication in a busy but efficiently operated court. Absent immediate judicial action, Alliance would have been left with a multimillion dollar judgment on which it could collect not a penny.[6] In my view, the District Court

[6] Before the District Court, Alliance frankly acknowledged the existence of other, unrepresented creditors. While acting to protect its own interest, Alliance asked the District Court to fashion relief that "does not just directly benefit us, but benefits ... the whole class of creditors" by creating "an even playing field" among creditors. (Alliance suggests

properly invoked its equitable power to avoid that manifestly unjust result and to protect its ability to render an enforceable final judgment.

At the hearing on the preliminary injunction, the District Judge asked: "We have got a case where there is no defense presented, why shouldn't I be able to provide [Alliance] with [injunctive] relief?" Why, the District Judge asked, should GMD be allowed "to use the process of the court to delay entry of a judgment as to which there is no defense? Why is that equitable?" The Court gives no satisfactory answer.

B

Contrary to the Court's suggestion, this case involves no judicial usurpation of Congress' authority. Congress, of course, can instruct the federal courts to issue preliminary injunctions freezing assets pending final judgment, or instruct them not to, and the courts must heed Congress' command. Indeed, Congress has restricted the equity jurisdiction of federal courts in a variety of contexts. See *Yakus v. United States*, 321 U.S. 414, 442, n. 8 (1944) (cataloging statutes regulating federal equity power).

The Legislature, however, has said nothing about preliminary freeze orders. The relevant question, therefore, is whether, absent congressional direction, the general equitable powers of the federal courts permit relief of the kind fashioned by the District Court. I would find the default rule in the grand aims of equity. Where, as here, legal remedies are not "practical and efficient," *Payne*, 7 Wall., at 431, the federal courts must rely on their "flexible jurisdiction in equity ... to protect all rights and do justice to all concerned," *Rubber Co. v. Goodyear*, 9 Wall., 805, 807 (1870). No countervailing precedent or principle holds the federal courts powerless to prevent a defendant from dissipating assets, to the destruction of a plaintiff's claim, during the course of judicial proceedings. Accordingly, I would affirm the judgment of the Court of Appeals and uphold the District Court's preliminary injunction.

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that District Court direct GMD to set up a trust in compliance with Mexican law in order to oversee distributions to creditors). The Court supplies no reason to think that Alliance should have abandoned its rock-solid claim just because other creditors, for whatever reason, failed to bring suit.

Comments and Questions

1. *Latin, really?* Pari passu? Arbitrio boni judicis? Ex aequo et bono? Lawyers love the Latin, don't they? What *do* these phases mean?
2. *Timing remedies*. As a matter of first principles, why should it matter whether an unsecured creditor has first obtained a judgment before exercising any control over the property of the debtor? To answer that question, should we know something about the relative ease of proof of the underlying alleged debt as against proof of the alleged actions that the debtor is 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. *English history*. 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?
4. *Historical context*. 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).
5. *What next?* It is good to get in the habit of asking after you have read a case, what happened next? That can be something as simple, as what happened next in the case procedurally? (And on that, see *Alliance Bond Fund, Inc. v. Grupo Mexicano de Desarrollo, S.A.*, 190 F.3d 16 (2nd Cir. 1999)). And it can be more systematic, such as asking how interested economic actors would like alter their practicing going forward given the decision?
6. *Digging deeper*. There is something called the Internet—you may have encountered it once or twice—and we should take advantage of it whenever we can. The U.S. Supreme Court does not allow video cameras into the Court, but it does record both the oral argument in a case and the announcement of the opinion. You can hear both of those and read the transcripts for *Grupo Mexicano* at http://www.oyez.org/cases/1990-1999/1998/1998_98_231.

## 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 issued 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.

In 1998, a substantially revised version of Article 9 was issued by the ALI and NCCUSL. This was 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. Fifty-three jurisdictions have adopted Revised Article 9 (What? They added three states and I didn't know? 50 states, plus the District of Columbia, Puerto Rico and the U.S. Virgin Islands). That version of Article 9 also came with a new Part 7 setting forth transition provisions. Under 9-701, Revised Article 9 became effective on July 1, 2001. The idea behind this section was to try to create a synchronized start of the new statute across the country and not have different enactment dates in individual states create an inconsistent, if temporary, patchwork of old and new versions of Article 9 throughout the U.S.

In 2010, additional amendments were issued to deal with issues that had arisen under Revised Article 9 and versions of those amendments have been enacted in all fifty states and the District of Columbia and Puerto Rico. Part 8 of the 2010 statute sets out transition provisions for the new amendments and, critically, new 9-801 established an effective date of July 1, 2013. In addition to Article 9, Article 1 of the UCC provides some crucial general terms that apply throughout all of the UCC. Article 1 was last revised in 2001 and that version has been enacted in fifty-two jurisdictions (only Puerto Rico is a hold out at this point). You can find out the status in any state by going to the Uniform Law Commission's website at www.uniformlawcommission.com.

Given the pace of litigation—slow as molasses on a cold winter day in Chicago—we are still building up a meaningful caselaw under the new statute. We still are litigating old deals—deals implemented under the old statute—and it takes time for litigation to work its way up the court system. Litigants will inevitably look to cases under the old statute when they make their cases. All of that means that at least for awhile, we will all need to be 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 as revised in 2010. Where the 1998 version needs to be referenced specifically, the text will indicate that. A reference to the old statute will say so, or will be indicated as F9-xxx. In cases, some old statutory references remain, but I have moved towards references to the current statute and those replacement references are set forth in square brackets. As you should now understand, all I have done is used the table of disposition systematically to save you the trouble of doing so.

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. As noted already, 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. To simplify a little, 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 sets out the four steps:

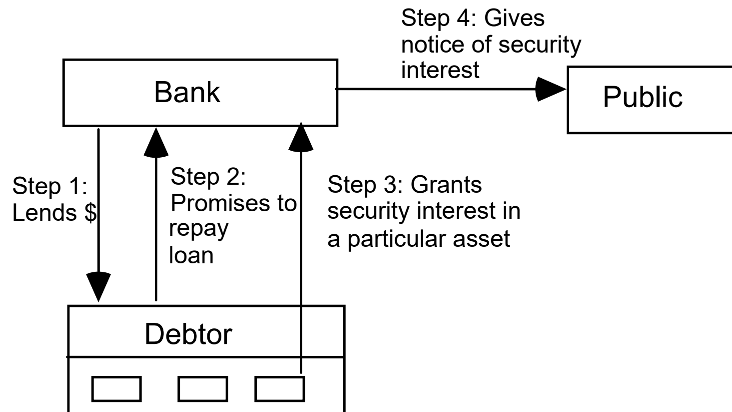


**Figure 1.1: Attachment and Perfection of Security Interests**

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.

*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(b)(35) defines "security interest" as "an interest in personal property or fixtures which secures payment or performance of an obligation." (Look also at 1-203 which addresses separating security interests and leases.) 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 obliga-

tion." 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.)

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 owned 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.

9-203 still permits security interests to be created by transferring possession, but most security interests 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)(74), 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 1-204, 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 the 1998 amendments, 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. For many years, debtors were required to sign the financing statement, but this was dropped in the 1998 amendments 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 considerably simplifies filing financing statements and reduces 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. The idea of a lien isn't consistently defined in all situations, but think of a lien as an interest in property that has arisen without consent. 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.

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 authorized 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; a second exception in Revised Article 9 is perfection through control, which bears a close relationship to possession. 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 Home Depot to buy a washing machine and having to inquire about the firm's 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 Home Depot 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 gives the federal government a lien on damaged real property cleaned up by the government. It matters a great deal whether that lien is junior to or superior to a competing security interest.

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. That means that we need to understand the Bankruptcy Code too.

CHAPTER TWO

# ATTACHMENT

9-109, the basic section defining the scope of Article 9, states that it applies to "a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract." Whether a security interest has been created, though, depends on whether the parties have met Article 9's formal requirements. If so, the security interest "attaches" and is enforceable between the parties, 9-203(a), (b), and is also effective (i.e., enforceable) against general creditors as well. See 9-201. If the security interest is attached (and no more), it will be at risk of being rendered ineffective against perfected secured creditors, lien creditors, or, most significantly perhaps, the trustee in bankruptcy. To protect the merely-attached security interest from these risks, an additional step is required: the secured party must have "perfected" its security interest—a status that usually requires more, but never requires less, than "attachment," 9-308(a). The additional steps necessary for perfection (such as the filing of a financing statement) are the ones that are designed to put third parties on notice of the agreement between the secured party and the debtor. These additional steps are, however, irrelevant until the agreement becomes enforceable as between the two parties (or, to use the language of Article 9, until the security interest "attaches"). Thus, attachment is a necessary step in the life of a security interest, for it both defines the moment when the interest first becomes enforceable at all and supplies a necessary ingredient to the desired status of a perfected security interest.

9-203(b) sets forth the basic rule for the creation of a security interest. Putting to one side special rules for certain property types, it sets out five requirements: (1) we must have a security interest; (2) either the secured party has possession of or control over the collateral under an agreement with the debtor or the debtor has authenticated a security agreement; (3) absent possession or control, the security agreement must contain an adequate description of the collateral; (4) the debtor must have rights in the

collateral or the power to transfer rights in the collateral; and (5) value must be given. In this chapter, we look at each of these in turn.

## Section I. The Idea of a Security Interest

Section 1-201(b)(35) sets forth the definition of a security interest. The first sentence provides that security interest "means an interest in personal property or fixtures which secures payment or performance of an obligation." Consider that sentence and the following fact patterns:

2-1: THE SIMPLE SECURITY INTEREST

- Debtor approaches Bank for a $10,000 loan. Bank is willing, so long as adequate security is given.
- Debtor executes a promissory note in Bank's favor and also signs a separate document stating that "Debtor hereby grants a security interest in its copier, serial no. 12345678, to Bank to secure the debt evidenced by that certain promissory note of even date herewith." Bank then lends Debtor $10,000.

¤ What are Bank's rights? See 1-201(b)(35), 9-203.

2-2: AFTER-ACQUIRED PROPERTY

- Debtor, a seller of rare books, expects to receive good title to a first edition of *Das Kapital* in six months, but it has no interest in the book today. Of course, Debtor wants to borrow money today.
- Banks lends Debtor $10,000 pursuant to a contract that provides that "Debtor hereby grants a security interest in all of its inventory, equipment, and general intangibles of whatever kind or type, now or hereafter owned by Debtor, including, without limitation, any first edition of *Das Kapital* that Debtor comes to own."
- Six months later, with the loan and the contract still outstanding, Debtor receives title to the book.

¤ Does this create a security interest in the book at any time, and if so, when? See 9-204(a), 9-203(a), (b).

2-3: WAIVING THE RIGHT TO SEIZE COLLATERAL

- Bank lends Debtor $10,000 under a contract that provides that "Debtor hereby grants Bank a security interest in equipment, but Bank hereby waives its rights under 9-609 to repossess the collateral after a default."

¤ Does Bank have a security interest under Article 9? See 9-609.

2-4: WAIVING PRIORITY RIGHTS

- Bank lends money as before, but the contract provides that "Debtor hereby grants Bank a security interest in equipment, but Bank must share the value of such equipment on a pro rata basis with Debtor's unsecured creditors if Bank repossesses and sells such equipment."
- ¤ Does Bank have a security interest under Article 9?

2-5: BUILDING THE SECURITY INTEREST BRICK-BY-BRICK

- Bank lends money as before, but the contract provides that "on default, Bank has the right to exercise those rights that a secured creditor would have under 9-609 of the Uniform Commercial Code."
- ¤ Does Bank have a security interest under Article 9?
- Suppose that the contract instead said "on default, Bank shall have the rights that a secured creditor would have under Part VI of Article 9."
- ¤ Does that change the outcome?

2-6: RESTRICTIONS ON ALIENATION

- On February 1st, Debtor borrows $10,000 from Bank and posts as collateral a rare first edition of Adam Smith's *The Wealth of Nations*. Debtor further agrees that it will not sell the book.
- On March 1st, Debtor purports to sell the book to Purchaser, notwithstanding its promise to Bank. Purchaser is unaware of that promise.
- ¤ Is the sale effective? What are Bank's rights? If Purchaser knew of the covenant not to sell, would that change the outcome? See 9-401.

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With these examples in mind, focus on the key question presented in the following case: Does Chrysler have a security interest in the liquor license?

## In re Clark

United States Bankruptcy Court, W.D. Pennsylvania, 1989.
96 Bankr. 605.

■ WARREN W. BENTZ, BANKRUPTCY JUDGE

* * * In July 1986, the debtor, Dick Clark (hereinafter "Clark") entered into a loan transaction with Chrysler First Consumer Discount Company ("Chrysler"), the proceeds of which were used to purchase the Wagon Wheel Restaurant, later renamed the "Laurel Valley Inn." To secure Clark's

obligation to repay, Chrysler attempted to protect its position by having Clark execute two instruments. Among them was a first mortgage in favor of Chrysler covering the premises purchased. The second, which was titled "Acknowledgement" (hereinafter the "Acknowledgement"), referred exclusively to liquor license TR-1793 (hereinafter the "License"), the terms of which agreement provide:

> ACKNOWLEDGEMENT
>
> We, the undersigned, do hereby acknowledge, consent and agree that liquor license TR-1793 issued by the Pennsylvania Liquor Control Board for use at premises situate(d) at R.D. # 1, Box 19, Ligonier, Pennsylvania 15650, will not be removed from said premises, nor transferred without the prior written consent of Finance America Consumer Discount Company, until mortgage loan from Finance America Consumer Discount Company to Diane C. Clark and Dick J. Clark a/k/a Richard J. Clark is paid in full.
>
> LAUREL VALLEY INN
> By /s Diane C. Clark
> By /s Dick J. Clark
> By /s Richard J. Clark

Furthermore, Clark signed a UCC-1 financing statement listing the License as additional collateral to secure repayment of the loan. The financing statement was subsequently filed in Westmoreland County and with the Commonwealth of Pennsylvania prior to the close of the transaction.

Subsequent to Chrysler's having advanced the funds and the execution of the Acknowledgement, the Pennsylvania Legislature amended 4-468 of the Liquor Code on June 29, 1987, adding subsection (d) which provides:

> 4-468. Licenses not assignable; transfers.
>
> ... (d) The license shall constitute a privilege between the Board and the licensee. As between the licensee and third parties, the license shall constitute property.

Finally, Clark filed his Petition for Relief under the Bankruptcy Code on or about April 26, 1988, thereby staying the enforcement of Chrysler's asserted security interest, whereupon it filed the Motion for Relief of the Automatic Stay and Request for Adequate Protection now before this court.

Chrysler also properly states the issues:

> 1. Whether or not the executed Acknowledgement is sufficient to satisfy the formal requirements of an enforceable security agreement?
>
> 2. Whether or not Chrysler's security interest attached at the time the Pennsylvania Liquor Code was amended in 1987 to state that a liquor license was to be treated as personal property as between the licensee and third parties?

[9-203] of the Uniform Commercial Code sets forth the requirements for an enforceable security interest. * * * Chrysler argues that it gave value when it advanced the sum of $85,000 to Clark enabling him to finance and close the purchase transaction shortly after the advance was made, and that determining whether Chrysler has an enforceable security interest in the License merely requires a finding that a security agreement was executed between the parties and that Clark ultimately acquired "rights in the collateral" citing *Kendrick v. Headwaters Production Credit Assoc.*, 523 A.2d 395 (1987).

[1-201(b)(35)] defines "security interest" as follows: "A security interest means an interest in personal property or fixtures which secures payment or performance of an obligation." [9-201] provides that: "Except as otherwise provided by this title, a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors." [9-102(a)(74)] provides the following definition: "'Security Agreement.' An agreement which creates or provides for a security interest."

Chrysler states correctly that the Code does not carefully define what exactly constitutes a security agreement, so that we must look to case law, citing *In re Bollinger Corp.*, 614 F.2d 924 (3rd Cir. 1980). That court observed certain prior interpretations * * * under which a "creditor's assertion of a secured claim must fall in the absence of language connoting a grant of a security interest." The court in *Bollinger* further noted that the requirement of "grant" language had been criticized and not followed by other courts which adopted a less strict rule, quoting with approval:

> A writing or writings, regardless of label, which adequately describes the collateral, carries the signature of the debtor, and establishes that in fact, a security interest was agreed upon, would satisfy both the formal requirements of the statute and the policies behind it. [*In re Numeric Corp.*, 485 F.2d 1328, 1331 (1st Cir. 1973) ]

The *Bollinger* court concluded: "The intention of the parties to create a security interest may be gleaned from the expression of future intent to create one in the promissory note and the intention of the parties as expressed in letters constituting their course of dealing."

Chrysler argues that the Acknowledgement (1) rendered the debtor unable to transfer the License thereafter to anyone else, including creditors and (2) precluded the debtor from transferring the License to a different premises, and is therefore sufficient as a security agreement. Chrysler concludes that it has a security interest in the License. However, while the Acknowledgement does constitute an agreement, and the parties are bound by its terms, and it identifies the License, its terms only provide limitations on the transfer of the License; the terms of the agreement do not indicate an intent to give to Chrysler a security interest in the License. Chrysler may prohibit a transfer of the License from the premises or prohibit the transfer of the License to an outside party, but it is given no right in the writing to foreclose on the License, to take possession of it, to have it canceled, to have it transferred to itself, to have any of the rights of a secured party under the Uniform Commercial Code, nor may Chrysler in any other manner derive a benefit from it except insofar as it may extract a ransom by being able to preclude a transfer by the debtor to another party or by the debtor to another premises.

We liken Chrysler's rights to the rights of a party to maintain a debtor's chicken within an enclosed, fenced-off area, under an agreement that the creditor might maintain the fence in place, preventing the chicken from being removed or used in any other place, or sold or transferred to any other person by the debtor, yet the secured creditor has no right in himself, on default or otherwise, to remove the chicken for his own benefit.

The outcome would be different if the writing had stated that Chrysler would have a security interest, for then Chrysler would have the right of possession under the Uniform Commercial Code upon default. And again, if the agreement had given, or evidenced an intent to give, Chrysler the right to possession upon default, then such a right could be enforced under the Uniform Commercial Code. But here, there is nothing to indicate an intent to give to Chrysler a security interest in the liquor license.

No doubt the debtors would have given Chrysler a security interest in the License if Chrysler had asked for it. It is apparent that Chrysler did not ask for a security interest. The obvious reason why Chrysler did not request a security agreement or security interest in the License was the fact that,

under the state of the law at that time, the License was not property and no security interest could be obtained in it by a creditor.

Thus, the attempted security interest must fail.

The above conclusion makes unnecessary our consideration of the other issue, that is, whether Chrysler's security interest would have attached at the time the Pennsylvania Liquor Code was amended in 1987. This court's view, though now unimportant to disposition of this case, is that when the legislation was enacted in 1987 changing the law so that thereafter a liquor license does constitute property, all of the elements would have fallen into place to create a valid security interest under [9-203] if the Acknowledgement had contained language evidencing an intent to grant a security interest. In many transactions, the financing statements, security agreements and value have been advanced prior to the time the debtor has an interest in the collateral. When the debtor acquires an interest in the collateral (e.g., when the purchased item is delivered to the debtor), that being the last necessary element of a valid security interest, the security interest thereupon attaches. There is no reason why such rule should not apply to a liquor license. Here, however, the fundamental element of a valid underlying security interest is missing. * * *

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Comments and Questions

1. *Simple v. Fancy*. There is nothing particularly special about *Clark*, but the point of the case and the problems leading into it is to try to examine right at the start of learning Article 9 how we should think about *constructing* a security interest. The good news is that there usually is a very simple answer to creating a security interest, just follow the standard form in doing so ("Debtor hereby grants a security interest in all of its inventory and equipment to secure all debts, now owed or hereafter owed, by Debtor to Lender"). But there could be situations where perhaps something more refined is called for and then understanding how the security interest can be unbundled, shaped and pulled back together might be useful.
2. *Licenses v. the value of the licenses*. Governmental license issuers will with some frequency place restrictions on the transferability of a license that may impinge on what secured creditors can do. That is frequently the case for liquor licenses—and those licenses are very important for most restaurants—but will also be the case, as we will see later, for big-ticket licenses such as FCC broadcast licenses. That said, a secured creditor

may not be that concerned about controlling actual transfer of the license so long as it can grab on the value given to its debtor when the license is transferred. That is a question of proceeds (see 9-102(a)(64) and 9-315), but, as we will see below, the difficulties of taking a security interest in the license itself can complicate how the secured creditor claims an interest in the proceeds of that license.

3. *State law variation*. The status of a liquor license as personal property is a question of state non-UCC law and there is no reason to expect state law to be uniform on that score. *Clark* made clear that Pennsylvania law had changed on exactly that issue and that means that secured creditors lending to holders of Pennsylvania liquor licenses can and do take security interests in those licenses. See *Ciprian Ltd. v. Oxford Development Company Grant Street, L.P. (In re Ciprian Ltd.)*, 473 Bankr. 669 (Bankr. W.D. Pa. 2012). For another example, this time in New Jersey, see *New Jersey v. United Trust Bank (In re Chris-Don, Inc.)*, 367 F.Supp.2d 696 (D.N.J. 2005). See also 9-408.

## Section II. The Requirement of an Authenticated Agreement

The key formal requirement for a generic security interest is given in 9-203(b)(3)(A): "the debtor has authenticated a security agreement that provides a description of the collateral." What does it mean to say that a debtor has to have "authenticated" a security agreement before a security interest can attach or become enforceable? (For some help, see 9-102(a)(7) and it is useful to know that the 2010 Article 9 amendments rewrote the definition of "authenticate.") In a transaction of any size, there will be a blizzard of documents evidencing the original transaction, plus a course of dealing after the fact. To what extent will we force subsequent secured parties to piece together the relationship from these documents and the dealings? Alternatively, should we enforce the authenticated agreement requirement rigorously and thereby force parties creating security interests to be especially careful?

We will look at two cases raising these issues. *Bollinger*, a Third Circuit decision from 1980, is the classic in the field, and then we will turn to a more recent case, *Caterpillar Financial*, from the Seventh Circuit in 2013. Before doing any of that, consider the following problems to set up *Bollinger*.

2-7: AGAIN AND AGAIN

- On January 1st, Debtor approaches Bank for a $150,000 loan. Bank is willing, so long as adequate security is given. Debtor executes a

security agreement in which it grants Bank a security interest in all of its equipment, then owned or thereafter acquired, to secure all debts, then owed or thereafter arising, of Debtor to Bank. An appropriate financing statement covering "equipment" is filed in the appropriate state office.

- On January 15th, Debtor does a similar transaction with Finco with another security agreement and financing statement covering equipment and borrows $10,000 from Finco.
- On February 1st, oddly, Debtor executes a second set of documents with Bank again conveying a security interest in equipment to Bank and again filing an appropriate financing statement covering equipment.

¤ What are Bank's rights? See 1-201(b)(35), 9-203, 9-322(a)(1).

2-8: AGAIN AND AGAIN AGAIN

- Replay the prior set of transactions, except instead of having Bank lend the entire $150,000 on January 1st, have Bank lend $65,000 on that date and an additional $85,000 on February 1st pursuant to a second lending agreement on that date.

¤ What are Bank's rights? Does splitting up the money alter the priority position of Bank and Finco? See 1-201(b)(35), 9-203, 9-322(a)(1).

## In re Bollinger Corp.

United States Court of Appeals, Third Circuit, 1980.
614 F.2d 924.

■ Rosenn, Circuit Judge

This appeal from a district court review of an order in bankruptcy presents a question that has troubled courts since the enactment of Article Nine of the Uniform Commercial Code (UCC) governing secured transactions. Can a creditor assert a secured claim against the debtor when no formal security agreement was ever signed, but where various documents executed in connection with a loan evince an intent to create a security interest? The district court answered this question in the affirmative and permitted the creditor, Zimmerman & Jansen, to assert a secured claim against the debtor, bankrupt Bollinger Corporation in the amount of $150,000. We affirm.

I

The facts of this case are not in dispute. Industrial Credit Company (ICC) made a loan to Bollinger Corporation (Bollinger) on January 13, 1972, in