

CHAPTER 6

UCC SECURITY AGREEMENTS

INTRODUCTION

A car loan is the most familiar UCC secured transaction. When you borrow money to buy a car, you sign at least two pieces of paper. One is the promissory note. This is the contract between you and the bank, where you agree to repay the loan at a certain interest rate with monthly payments. If you default on this “contract” or “promissory note,” the bank can file suit against you personally. The bank can obtain a judgment against you, which will enable them to attach your personal assets, garnish your wages, etc.

When placing the car loan, you also sign a “security agreement.” This security agreement gives the bank a “Security Interest” in the “Collateral” or “Security Property” (the car). The security agreement gives the bank the right to go against the collateral (car) if you default. The bank can repossess the collateral and can resell it to get payment on the loan. If the sale of the collateral is insufficient to repay the loan, the bank still has the right to sue you on the promissory note for any deficiency.

ADVANTAGES OF A SECURED TRANSACTION

In the typical secured transaction, the lender has two avenues to obtain payment: (1) a claim against the borrower personally, which will eventually enable the lender to go against all of the borrower’s assets, and (2) a claim against the collateral or secured property.

Obviously, the existence of two avenues gives the lender a greater chance of recovery.¹ The lender’s risk of non-collection is lower, thereby enabling the lender to offer lower rates. Thus, secured loans are usually cheaper for the borrower.

Secured creditors will usually have the same rights as a general unsecured creditor *and* will also have the first claim against the security property. A second creditor may file suit against the debtor unbeknownst to the secured creditor. The second creditor could obtain a judgment against the debtor and attach all of the debtor’s assets, including the security property. However, even though the secured creditor has not filed suit against the debtor and has not yet obtained a judgment, he or she will still have the first right to the security property. If the second creditor takes the debtor’s property to a judicial sale, the secured creditor will receive all of the proceeds from the security property up to the amount of the loan. A secured creditor, therefore, is not too concerned with the “race to the court house.”

Conversely, unsecured creditors are in a race to obtain a judgment. The first judgment creditor to attach the debtor’s assets will have priority over later judgment creditors. A secured creditor, however, already has a first priority lien in the security property, even without filing suit.

Bankruptcy ends the race to the courthouse.² All creditors are forbidden from racing to get judgment liens or otherwise improving their position once a petition for bankruptcy is filed. Once a petition is filed, general unsecured creditors will never be able to secure the amount owed to them, by judgment or otherwise. However, the secured creditor’s lien on property survives the bankruptcy.

The practical result of most bankruptcies is that all secured creditors get some or all of their money while general unsecured creditors get nothing. Security interests become most important, therefore, upon the debtor’s insolvency or bankruptcy.

WHEN SHOULD YOU TAKE A SECURITY INTEREST

When can the typical material supplier take advantage of a security interest? At what point in the typical credit transaction will the supplier have the opportunity to obtain security?

¹ See chapter, Credit Management; section, The Importance of Security.

² See chapter, Bankruptcy Primer for Creditors.

In practice, UCC security interests will often be unavailable to contractors or material suppliers. Customers often are unwilling to grant security interests for open account credit, and competition from other vendors most likely will keep you from requiring them. However, do not forget about security interests as a possibility, for they should be kept in your arsenal of credit management tools. You will often be faced with marginal customers whom you should turn away. A security interest may allow you to increase sales by accepting customers you would otherwise turn away. Ask the customer what business or personal assets are available to provide security. It will not hurt to ask this question of a customer to whom you would otherwise refuse to sell.

A contractor or material supplier can offer incentives to the debtor to provide security. The seller can offer its best credit terms, lower service charges or an increased discount in exchange for a security interest. The seller can offer these incentives because the seller's costs of doing business and risk of non-collection have been reduced.³ These risks are a part of the margin figured into every seller's price. Just as you can provide your best prices and terms to your longstanding creditworthy customers, you can do the same for a marginal customer providing you with good security.

Lower costs benefit the buyer who provides security; this idea should be "sold" to the customer in this fashion. A security interest in equipment or accounts receivable will not impact the customer's daily business as long as the terms of the credit agreement are met. The customer can still use the equipment or accounts receivable, but will be getting better prices on its material purchases month after month. This can add up to a great deal of savings with no cost to the customer.

You should continue to consider security interests throughout the life of your customer account, such as when the customer desires a higher credit limit or other accommodation. A customer is most likely to grant a security interest when the customer is in default. Most contractors are very dependent on their material suppliers to continue in business. If they cannot get materials, they cannot finish their projects—and cannot get their needed cash flow. Contractors are eternal optimists. They always believe that if they can finish the current project and obtain a new project, they will be able to "turn it around." This is an opportunity for you to obtain security for a pre-existing debt, discussed below, even if this customer was unwilling to provide security earlier.

Purchase Money Security Interest

When a lender provides the funds to a buyer for the purchase of goods, the lender can obtain a "purchase money security interest." In the typical heavy equipment sale, the excavating subcontractor purchasing heavy equipment needs to borrow money for the purchase. The seller of the heavy equipment, or the bank, lends money to the excavating subcontractor to purchase the equipment. The heavy equipment seller, or the bank, will "retain" a purchase money security interest. If the excavating subcontractor grants a lien on this equipment at any later time, after its purchase, the security interest will not be a purchase money security interest.

Any seller of goods on credit has the opportunity to request a purchase money security interest. The principle advantage of a purchase money security interest is that this interest will have a special priority over other security interests in the same property, if special rules are followed.⁴ The UCC favors a seller who lends money to make a sale, because the debtor/buyer would not have the goods if the seller had not extended credit to buy them. Therefore, the UCC gives the seller/lender first priority in the goods sold.

A purchase money security interest will work best for a seller of durable goods, which the buyer will retain for a long period of time. The heavy equipment seller is a good example. A supplier of groceries to a restaurant will not be as interested in a purchase money security interest, because the goods are quickly resold or deteriorate in value as they age. A construction materials supplier usually has this same problem. The lumber supplied to a carpentry contractor will soon be resold to the homebuilder and incorporated into the real property. The homebuilder will usually require the carpentry subcontractor to convey the lumber "free of liens" and "free of any security interest."

For these reasons, the construction material supplier may prefer other security options, such as mechanic's lien rights. However, it may still be possible to obtain a purchase money security interest in construction materials, which will continue as a security interest in the debtor's proceeds of sale. The carpentry subcontractor is allowed to convey the lumber to the homebuilder free of liens. The lumber supplier, who has a purchase money security interest, now has a security interest in the cash received by the carpentry subcontractor from the homebuilder. The cash proceeds will quickly be commingled with the carpentry subcontractor's other funds, so "tracing" can become a problem.

³ See chapter, Credit Management; section, The Importance of Security.

⁴ See section below, Perfection of Security Interest.

The lumber supplier then will have to show where the money for the lumber went. The carpentry subcontractor should use the funds promptly to pay the lumber supplier, payroll and other vendors. A security interest in proceeds, therefore, may not be long lived.

A material supplier never knows when a bankruptcy will hit a customer. If a bankruptcy hits soon after a sale, a purchase money security interest in materials sold, with a continuing interest in proceeds, may provide the material supplier security for a recent sale. The material supplier will be a secured creditor for at least those recent sales, instead of joining the ranks of totally unsecured creditors.

Security Interest in Other Property

A lender can request a security interest in any of the debtor's property. All assets of the debtor/customer are candidates for security. The best possibilities for UCC security interests will probably be in equipment or accounts receivable of the debtor. A security interest in real estate is also possible, although this would not be a UCC security interest.

Security Interest for Ongoing Line of Credit

A materials supplier can require a continuing security interest for an ongoing line of credit. A supplier can require a security interest upon the opening of the account or later as a condition to continue the account or increase the credit limit. This most likely will work when the customer is very dependent on one supplier to continue its business. It should always be considered as a possibility, especially with a marginal customer. If faced with a customer you would normally disqualify on credit grounds, consider a security interest. This is an opportunity to increase sales that would otherwise be turned away.

Security Interest for Existing Debt

There will come a time that your customer needs you very badly. They may have exceeded their credit limit or may be in default of the credit agreement. They may need additional materials to complete a project, and they will be unable to get paid on the project until it is completed. You may already have threatened legal action.

There comes a time that you must "cut off" a customer. There is no point in throwing good money after bad. This presents an age-old problem, however. If you cut the customer off, he will not be able to finish the project and cannot obtain the funds to pay you. Also, if you refuse to ship, the customer may get angry and stop payments altogether.

This situation creates a tremendous opportunity to obtain security for new shipments and to obtain security for the existing debt. Because this customer needs you badly, the customer may be willing to provide the security he would not consider when he opened the account. Now, you have an opportunity to "work with the customer," get through credit problems and dramatically improve your own position.

Even if you are about to "go legal" on the customer, you should consider a security interest. A customer may plead with you not to file a mechanic's lien or file suit. You can agree to do this in exchange for other adequate security. It is worthwhile to do this, even if it means waiting longer for payment or extending additional credit. If you continue to push the customer legally, it will probably take months to obtain a judgment. Many other creditors will be "racing you to the court house." It is very much worth your while to offer incentives to the borrower to provide security. Other creditors obtaining judgment liens months from now will have an inferior interest in the same property in which you obtain a security interest now.

The best possibility for security in these situations is accounts receivable. How often has a debtor told you that you will be paid as soon as they collect on a particular project? It is advantageous to take a debtor at his word. This is the fastest way to find out whether the debtor means what he says. Suggest that the debtor grant a security interest in that single receivable. The debtor has told you that the receivable is your money. What does it hurt to put that in writing? You probably don't even have to file a financing statement to perfect this security interest if it is not a significant part of the outstanding accounts of the debtor.⁵ A simple letter identifying the collateral, stating that the debtor "assigns" this receivable to you or grants you a security interest in it, and signed by the debtor will probably be sufficient. If 90 days pass without a bankruptcy, you are a secured creditor. The Assignment of Funds in the Appendices is an example of a simple assignment of accounts receivable.

⁵ See subsection below, Collateral with No Filing Requirement.

The Effect of Bankruptcy

A bankruptcy will stop all legal action against the debtor. Often, when many vendors begin pushing a debtor legally, a bankruptcy follows. Whenever you “go legal” against the debtor, you run the risk that a bankruptcy will stop you from obtaining security or that all of the debtor’s assets will be gone by the time you obtain judgment. Obtaining a security interest now avoids both of these problems. As long as the debtor can make it 90 days after providing you with a security interest without filing bankruptcy, your security interest will survive the bankruptcy, while other creditors may be unable to collect.

TYPES OF SECURITY PROPERTY

Under the UCC, you can obtain a security interest in almost any type of personal property. The most likely candidates are:

1. Inventory
2. Fixtures
3. Equipment
4. Vehicles
5. Accounts receivable
6. Stocks, bonds and negotiable instruments.

Inventory

If you are in the business of selling materials, you may consider keeping a security interest in all of the goods purchased by your buyer. This may qualify as a purchase money security interest.⁶ If your buyer resells the materials and receives cash for them, you now have a security interest in those cash proceeds for a limited period of time.

A security interest in proceeds will not continue long without taking additional action. It is important, therefore, to require prompt payment from the debtor once your collateral has been sold. In the event of bankruptcy, the continuing security interest in proceeds will be important to preserve your secured claim in proceeds derived from recent sales by the debtor. You will also continue to have a security interest in the debtor’s unsold inventory.

Fixtures

It is possible to perfect a security interest in fixtures such as HVAC equipment and plumbing and electrical fixtures that are incorporated into the debtor’s real estate. In general terms, fixtures are goods (materials) that “become so related to particular real estate that an interest in them arises under real estate law.”⁷ They usually could be removed without damaging the real estate and are kind of a hybrid between personal property and real estate. If you sell such items that are to be installed on the debtor’s real estate, you may consider taking such a security interest. The rules for perfecting a security interest in fixtures are somewhat complicated and are beyond the scope of this discussion.

Equipment

If you sell equipment, you will certainly want to retain a purchase money security interest in the equipment sold.⁸ If you are not an equipment seller, you can also take a security interest in equipment already owned by the debtor. Excavating and other heavy construction contractors often have valuable equipment.

⁶ See section above, When Should You Take a Security Interest; subsection, Purchase Money Security Interest.

⁷ Va. Code Anno. §8.9A-334(a) (Michie 1950); *In re Vincent*, 468 B.R. 802, 803 (Bankr. E.D. Va. 2012) [A security interest may be created in goods that are fixtures or may continue in goods that become fixtures. A security interest does not exist in ordinary building materials incorporated into an improvement on land. Siding and windows are “ordinary building materials.” It is not contested that they were incorporated into the house. Once incorporated into an improvement on land, no security interest in them exists. Rather, the priority of claims to the building materials are determined by the law governing claims to real property].

⁸ See section above, When Should You Take a Security Interest; subsection, Purchase Money Security Interest.

Vehicles

You can take a security interest in vehicles, but remember that liens on vehicles licensed by the Division of Motor Vehicles (DMV) must appear on the title to the vehicle. These liens should be filed with the DMV and not filed by a UCC financing statement.⁹

Accounts Receivable

You can take a security interest in all of the debtor's accounts receivable generally or in a few specific account receivables. You may not even need to file a UCC financing statement to perfect a security interest in one or two account receivables.¹⁰

In your security agreement, you will want the right to contact the debtor's customer to get direct payment. The Security Agreement in the Appendices has this and other protective terms.

Stocks, Bonds and Negotiable Instruments

Negotiable instruments are promissory notes or checks. If your debtor claims that its money is tied up in money owed by others, you can request a security interest in the evidence of that debt. You can take a security interest in a promissory note owed to your debtor in the same way that you can take a security interest in account receivables.

You can also take a security interest in any stocks or limited partnership interests owned by the debtor. You can even request that the owner of the debtor's corporation grant you a security interest in the stock of the corporation itself.

Remember that you may need to take possession of stock, bonds or negotiable instruments in order to protect an effective a security interest in them.¹¹

Real Estate

Real estate owned by the debtor or a related principal is often the best candidate for a security interest. Security interests in real estate are not covered by the UCC but are covered by other state law. Accordingly, they are not discussed in this outline, but don't forget about security interests in real estate as a possibility. The Security Agreement in the Appendices discusses real estate. The law on real estate security interests varies from state to state. Care must be taken and help from a lawyer is probably necessary.

After Acquired Property

It is possible to obtain a security interest in property "now or hereafter" owned by the debtor. This is especially common in the case of a security interest in inventory that is continually turning over. Your debtor's credit line bank probably has also perfected this type of security interest in any property the debtor acquires in the future.

Floating Liens

Large institutional lenders often require a "floating lien" on all of the currently owned and after-acquired property of the debtor. Any of your customers with a large bank credit line have probably granted such a security interest in all inventory, equipment and accounts receivable now owned or hereafter owned by the debtor. Whenever you are considering a security interest in connection with a credit transaction, you should ask what other security interests exist in the property.¹² Security interests that the debtor has granted will usually appear on credit reports such as those produced by Dun and Bradstreet. You will probably want to order a record search to determine whether your debtor has granted a floating lien or a security interest in any particular piece of property.¹³

PERFECTION OF SECURITY INTERESTS

You must "perfect" your security interest to make sure it is enforceable *against third parties*. A security interest will be enforceable against the debtor, whether or not it is perfected. If you have an agreement providing a security

⁹ See section below, Perfection of Security Interest; subsection, Searching for Financing Statements.

¹⁰ See section below, Perfection of Security Interest; subsection, Collateral with No Filing Requirement.

¹¹ See section below, Perfection of Security Interest.

¹² See section below, Priority of Security Interest.

¹³ See section below, Perfection of Security Interest; section, Searching for Financing Statements.

interest in equipment, you will be able to repossess that equipment on default regardless of whether you have taken all the necessary steps to perfect your interest. The problem arises when someone other than the debtor appears on the scene. What if the debtor has sold the equipment to someone else? What if some other creditor claims a security interest in the same equipment?

Battles over the perfection and priority of various security interests are rarely between the secured creditor and the debtor. More likely, these battles are between different creditors over who has first priority to the debtor's property. To perfect a security interest, a creditor must make sure that it has given proper notice to the rest of the world that a security interest in the property is claimed.

Security Agreement

A creditor must have a security agreement with the debtor to have a valid security interest. The security agreement must:

1. be signed (or authenticated) by the debtor and the owner of the property,
2. contain a description of the collateral and
3. make it clear that a security interest is intended.

A security agreement need not be complicated. A simple letter from the debtor can suffice as long as it is signed by the debtor and the property owner, adequately describes the collateral and makes it clear that a security interest is granted. It is advisable to have your security agreement recite that the creditor is allowed to file a UCC-1 financing statement in the public records. Forms can also be used; the Security Agreement in the Appendices is an example of a form that grants rights in a variety of collateral as well as additional legal rights. A security agreement can provide for the:

1. Collateral to be kept in a certain location
2. Collateral to be maintained in good condition
3. Creditor to examine the collateral
4. Debtor to keep the collateral insured
5. Creditor to obtain direct payment on collateral accounts receivable
6. Creditor to institute legal proceedings to collect collateral accounts receivable
7. Debtor to be required to collect and deliver the collateral to the creditor on default
8. Debtor to pay legal fees on default.

You should consider having a form developed for your common credit transactions that includes the protection you need but eliminates unnecessary language that will concern debtors.

Signature by Debtor and Owner

The debtor or an authorized agent must sign the security agreement. Security agreements can be ruled invalid because of mistakes in the debtor's name. Be careful of related entities to make sure that the signature on your security agreement matches the correct legal name of the debtor.

The owner of the collateral property or an authorized agent must also sign if the property owner is different from the debtor. This can occur, for example, where your debtor is an excavating subcontractor, and all of its equipment is in the personal name of the corporate debtor's president. You must also be careful of the existence of related entities. Make sure you get the debtor's and the owner's correct names. You may need to require evidence of ownership of any collateral property.

Description of Collateral

The description of the collateral must be sufficient to identify it. Serial numbers would certainly be sufficient for equipment, and a typical inventory list should be sufficient for inventory. Try to get as complete a description as possible. Consider attaching exhibits to describe the collateral, such as certificates of title, invoices or shipping lists created when the debtor purchased the property.

Words of Grant

The security agreement must contain a few simple words showing that a security interest is intended. Stating that the debtor “hereby grants a security interest in” the collateral is sufficient. An agreement stating that the “creditor has loaned \$10,000 to the debtor for the purchase of certain equipment” does not qualify as a security agreement since it is not clear that a security interest is intended.

Financing Statement

The financing statement, often referred to as “UCC-1,” is the document that is filed in the public records. A financing statement must include:

1. The names and addresses of the debtor (or at least the owner) of the collateral
2. The name and address of the secured party, from which further information about the security interest can be obtained
3. A description of the collateral.

Forms are usually used for this purpose. The UCC-1 Financing Statement in the Appendices is a form that will be acceptable in most states. You will notice that the requirements for a security agreement and the requirements for a financing statement are very similar. The only additional requirement of the financing statement is that it includes the name and address of the secured creditor. A security agreement can also qualify as a financing statement if it includes all of the above, although some state government clerks only will accept the approved UCC-1 form. It is advisable to have your security agreement recite that the creditor is allowed to file a UCC-1 in the public records. However, by signing a security agreement, the debtor normally automatically authorizes the creditor to record a UCC-1 without another signature from the debtor.¹⁴

The UCC-1 Financing Statement in the Appendices has been altered to include a signature for the debtor and words of grant. If properly filled out, this form can also operate as a security agreement and a UCC-1 Financing Statement, although it is probably better and safer to have a separate security agreement and financing statement. If you use the UCC-1 form without a separate security agreement, it is advisable that the UCC-1 form contain a more detailed description of the collateral.

Large institutional lenders will often have lengthy security agreements. However, the lender and debtor often want to keep their agreement private. The one-page financing statement meets the statutory requirements for filing while providing the minimum information to the public. The UCC-1 informs the public that a security interest exists and provides an address to obtain further information. The balance of the security agreement can be kept private.

Where to File a Financing Statement

The original model Uniform Commercial Code provided three alternative places for filing the financing statement. As different states adopted the UCC, they picked various combinations of those three alternatives. Accordingly, the filing requirements varied from state to state. This could cause problems when the debtor, the creditor or the collateral were located in different places. Dual filing was also required in many states, where the UCC-1 had to be filed in the state capital and in the county of the debtor’s principal place of business.

The recent revisions to the Uniform Commercial Code now recommend a centralized filing requirement, where it is necessary to file the UCC-1 only in the state capital in the debtor’s state of incorporation. All states have now adopted this practice. This rule will cover the vast majority of situations. Different rules may apply in the case of fixtures installed on real estate, equipment used in farming operations, grain or other farm products, mined resources or timber. Such collateral closely related to real estate requires special research and care.

Virginia now has a centralized filing requirement. Under previous versions of Virginia’s Code, dual filing was required in most situations. The financing statement had to be filed with the State Corporation Commission in Richmond and in the county land records of the debtor’s place of business. With amendments adopted in 2001, Virginia only requires central filing with the State Corporation Commission in most instances. Maryland already

¹⁴ Va. Code Anno. §8.9A-509(b) (Michie 1950) [Security agreement as authorization. By authenticating or becoming bound as debtor by a security agreement, a debtor or new debtor authorizes the filing of an initial financing statement, and an amendment, covering the collateral described in the security agreement ...].

had a single filing requirement in most situations. The financing statement must still be filed only with the State Department of Assessments and Taxation in Baltimore.

Searching for Financing Statements

The most effective place to search public records for UCC financing statements is at the central filing place.

In Virginia, this is at the State Corporation Commission in Richmond at 804-371-9733 or 866-722-2551 (toll-free in Virginia only) or https://cisiweb.scc.virginia.gov/z_container.aspx or the Clerk's Information System at: <http://www.scc.virginia.gov/clk/uccsrch.aspx>.

In Maryland, this is the State Department of Assessments and Taxation's Corporate Charter Division at 410-767-1340 or 888-246-5941 (toll-free in Maryland only) or <http://sdatecert3.resiusa.org/ucc-charter/>.

In Pennsylvania, this is at <https://www.corporations.pa.gov/search/uccsearch>.

In the District of Columbia, you have to register at this site in order to access online public records: <https://gov.propertyinfo.com/DC-Washington/#>.

All financing statements must be filed in this central location. For attorneys licensed in Virginia, the Virginia State Corporation Commission will also complete a simple check for a small fee. Commercial vendors are available to perform searches and file UCC Financing statements at a reasonable cost, including the NACM MLBS-UCC Filing Services at 410-302-0767 or <http://www.nacmsts.com> or NCS at 800-826-5256 or CT Lien Solutions at 800-777-8567 (Baltimore office).

A security interest in fixtures could be filed either in the central location or the locale (county) where the real estate is located.¹⁵ In general terms, fixtures are goods (materials) that could be removed without damaging the real estate and are kind of a hybrid between personal property and real estate. Examples would be lighting fixtures or HVAC equipment. You must remember to check in the county land records and the state capital to see if there are prior liens in fixtures.

Remember also that liens or security interests in a vehicle licensed by the Department of Motor Vehicles require a "Certificate of Title" from the Department of Motor Vehicles. Any liens or security interests must appear on the Certificate of Title itself. Motor vehicle lien documentation must be filed with the Department of Motor Vehicles, not with the State Corporation Commission.

Collateral with No Filing Requirement

Security interests and some types of collateral can be perfected without filing a UCC financing statement. Remember that you will still need a security agreement granting you the security interest even if it is not necessary to file a financing statement.

Possession

A security interest can be perfected in many types of collateral by taking possession. A pawn shop business depends on this type of security interest. The debtor brings jewelry, stereo equipment or other collateral into the pawnshop. The debtor then signs a security agreement, and the pawnshop keeps the collateral. The pawnshop need not file a UCC financing statement. This arrangement could work well for you in the case of short-term loans. Merely taking possession can perfect security interests in goods, stocks, bonds and negotiable instruments.

Accounts Receivable

It is not possible to "see and touch" an account receivable. Therefore, most lenders perfect a security interest in receivables by filing a financing statement.

It is not necessary to file a financing statement, however, for a security interest in an account receivable that is not "a significant part of the outstanding accounts" of the debtor. This is obviously a vague standard. If you have a choice, it is preferable to record a financing statement to perfect this security interest. If you obtain a letter agreement assigning a single account receivable to you, however, it is probably not necessary to file a financing statement. The Assignment of Funds in the Appendices is an example of a simple assignment of accounts receivable.

¹⁵ Va. Code Anno. §8.9A-501 (Michie 1950).

Five-Year Continuation Statement

Financing statements are valid for five years. A “continuation statement” may be filed within the last six months prior to the expiration date. A continuation looks very similar to a financing statement. It must be signed by the secured creditor, must give the filing number of the original financing statement and must state that the original financing statement is still effective.

PRIORITY OF SECURITY INTERESTS

Generally

The priority of security interests in personal property is very similar to the priority of liens on real estate. Generally, whichever secured creditor has “perfected” the security interest first will have the first priority. In order to perfect, the secured creditor must have a valid security agreement and in most cases, file a valid financing statement. If the debtor becomes insolvent, there will be insufficient assets to pay all of the creditors. Other creditors will attack any security interest that has a weakness. As a result, the technical rules on perfection must be followed closely. For this reason, you should be concerned about a prior “floating” or “blanket” lien from a bank if you are considering taking a security interest from a debtor.

If you are the second creditor to perfect a security interest in certain property, you have a second priority lien. The first priority creditor must be paid in full before you will receive proceeds from the sale of the collateral.

A security interest will be helpful to you even if another lender’s lien is prior. First, the security interest will still give you a “hammer” that allows you to quickly get the debtor’s attention. Filing suit to obtain a judgment can take months. However, a security interest in equipment can empower you to immediately repossess equipment. A security interest in accounts receivable can allow you to contact the debtor’s customer’s for direct payment even before any default, if this right is in your security agreement. Under the UCC, the secured creditor always has the right to directly collect an account receivable after default.

Second, you may be able to require a superior lender to “marshal assets.” If one lender has a security interest in multiple pieces of property, it cannot destroy another lender’s security interest in just one piece of property unless it is necessary to collect the debt. In other words, the superior creditor can be required to go against all other property of the debtor before it goes after the piece of property in which you have a security interest.

Purchase Money Security Interest

If you sell goods on credit, lending your customer the money to purchase, you are a “purchase money lender.” If you retain a security interest in the goods you sell in order to secure payment from the debtor, this is a “purchase money security interest.”

Purchase money security interests receive a special priority under the UCC. Remember the “floating liens” or “blanket security interests” discussed above. Such floating liens can cover after acquired property of the debtor. If the debtor acquires new equipment, for example, the floating lien attaches to the equipment as soon as the debtor acquires title.

If you were an equipment seller, you would not want to sell equipment on credit to such a debtor. You could never acquire a first priority lien on the equipment. To solve this problem, the UCC creates an exception to the general rules on priority for purchase money security interests.

In the case of most goods or collateral, the purchase money lender must perfect its security interest quickly after the debtor obtains possession of the goods sold to maintain its priority. If the security interest is perfected within this time limit, it will have priority over security interests perfected earlier.

In the case of a purchase money security interest in inventory, the security interest must be perfected before the debtor obtains possession, and the purchase money lender must give notice to all prior secured parties of the intention to acquire a purchase money security interest in the inventory *before* the debtor takes possession. If the goods you are selling will be in your debtor’s inventory, you must perform a search of UCC filings to see if any other creditor will have a competing security interest in the debtor’s inventory. The filed financing statements will tell you the name and address of the prior secured party. You must send a notice to all prior secured parties describing the goods you intend to sell and indicate that you intend to retain a security interest in them.

