

The Legal Framework to Secure Loans in the United States: A Comprehensive System for Creating Security Interests

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Basic principles

Six basic principles underlie the law governing the creation of personal property secured transactions in the United States. These principles include:

- a unitary conceptual framework should govern all security devices;
- the substance of a transaction rather than its form should determine the applicable legal rules;
- ownership or title to property should play a very minor role in determining the rights of the debtor and secured party or the priority of claims to the collateral;
- the debtor should be able to use the same property as collateral to secure obligations to more than one creditor;
- there should be minimal limitations on the right of any person to create a security interest in that person's property in order to secure present and future obligations owed to any creditor; and
- the debtor should be able to create a security interest in a fluctuating mass, such as inventory or accounts receivable.

Principle 1: A unitary conceptual framework

Before the first official text of the Uniform Commercial Code in 1951, non-uniform state law governed security interests in movable property. Non-statutory common law rules governed some devices, such as the pledge. State legislation regulated other devices, such as chattel mortgages and conditional sales.

This legislation was not uniform among all the states, even for the same security device. Article 9 of the Uniform Commercial Code replaces these non-uniform rules for different security devices with a unitary conceptual framework.

Principle 2: Substance over form

Substance rather than form determines whether Article 9 applies to a particular transaction. No matter how the parties describe or label a transaction, a security interest in movable property is created if the transaction functionally gives a creditor an interest in movable property that secures payment or performance of an obligation. Thus, the sale with the retention of title and the consignment of property for resale will be secured transactions. Article 9 will also govern an outright sale or lease of property if the substance of the sale or lease transaction is to transfer a security interest. (Article 9 expressly covers the sale of certain property, such as receivables, because it is so difficult in practice to distinguish between the sale of this property and the transfer of a security interest in the property.)

Principle 3: Minimal relevance of title to collateral

Who owns or has title to property plays a minimal role in the law of personal property secured transactions. The parties' rights, obligations and remedies set out in Article 9 apply whether or not the secured creditor or the debtor has title to the property. For example, the debtor merely must have rights in the property (or the power to transfer

rights) in order to create a security interest. Thus, a lessee of goods may grant a creditor a security interest in the lease interest even though that interest is not a full ownership interest. The lessee may do so without the permission of the lessor who owns the property, although to do so may be a breach of the lease agreement. As a business matter, of course, the creditor may not consider this limited interest adequate collateral. Nevertheless, the law does not prohibit the lessee from granting such a security interest.

Principle 4: Collateral may secure obligations to more than one creditor

After a debtor creates a security interest in his property both the debtor and the secured party have in rem rights in the collateral. The secured party will have a security interest while the debtor continues to have property rights, such as the right to possess and use the property. The debtor has the power to transfer its rights without the consent of the secured party. This transfer may be voluntary or involuntary. For example, the debtor may voluntarily grant a security interest in the same collateral to a later creditor or a judgment creditor of the creditor may obtain an involuntary lien in the debtor's interest. The transfer of the interest may be a breach of the debtor's security agreement with the first secured party. If so, the transfer may trigger the secured party's right to take possession of the collateral.

Principle 5: Minimal limitations on the creation of security interests

Article 9 has minimal limitations on the granting of security interests in all forms of movable property to all kinds of creditors by all kinds of debtors to secure all obligations to pay or otherwise perform. The broad scope of this principle may be illustrated by isolating each component of this statement of the principle.

There is no requirement that the property or the persons be commercial. Any debtor, whether a consumer or Ford Motor Company, may grant a security interest.

The interest may be granted to any creditor, whether Bank of America or a neighbor who sells a used refrigerator on secured credit.

The parties may agree to secure any obligation. In most cases, the secured obligation will be an enforceable promise to pay money. In principle, however, other obligations may also be secured.

The parties may agree that the obligations secured include not only those existing at the time of the security agreement but also those obligations that arise in the future (i.e., future advances). There is no time limit on the future obligations that may be covered by a security agreement.

With few exceptions (such as the transfer of a claim for wages), the debtor may grant a security interest in all its movable property, whether tangible or intangible. In particular, a debtor may grant a security interest in property the debtor may acquire at a later time (i.e., after-acquired property).

Principle 6: Fluctuating masses may serve as collateral

Consistent with Principle 5, Article 9 makes it relatively simple to create a security interest in inventory and receivables. Among the legal rules that makes financing secured by this floating lien possible are the rights to secure future advances and the to grant a security interest in after-acquired property. In addition, three other legal rules support this form of financing.

The security agreement does not need to specify collateral item by item. The description of the collateral must merely reasonably identify the collateral. A description of the collateral as all the debtor's assets is not effective.

A secured party is automatically entitled to the proceeds received by the debtor when the debtor sells or otherwise disposes of collateral. These proceeds include whatever can be identified as having been received in exchange for the original collateral. The secured party's right in the proceeds is an in rem right; the original security interest attaches to the proceeds automatically. It logically follows that if the debtor disposes of the proceeds the secured party is entitled to the proceeds of the proceeds.

The parties need to file only an initial financing statement with the public register without the need for additional filings as new items are acquired.