INTRODUCTION

A lien is a relationship between a debt and property. The debt is referred to as the *obligation* and the property is referred to as the *collateral*. The relationship is that if the obligation is not paid when due, the creditor has the right to have the collateral sold and to be paid from the proceeds of sale.

Liens are at the heart of the system for government-assisted debt collection. When the law forces the payment of a debt, the enforcement is the enforcement of a lien. An obligation for which a lien exists is referred to as *secured*; an obligation for which no lien exists is referred to as *unsecured*. Every legal obligation that can be satisfied through the payment of money is either secured by collateral or unsecured. To enforce an unsecured debt, the creditor must first obtain a lien.

Secured obligations are often referred to by the type of collateral involved. They are called home loans, car loans, inventory loans, and farm crop loans, to mention just a few. Among the credit extensions usually made on an unsecured basis are credit cards, bonds issued to investors by large companies, student loans, loans between friends, trade credit (a business's purchase of goods or services on credit), and many loans by commercial banks and insurance companies.

Liens come in a variety of types. *Security interests* are consensual liens against personal property; *mortgages* are consensual liens against real property. *Statutory liens* are liens created by federal or state legislation. They include tax liens, mechanic's liens, agricultural liens, attorneys' liens, and many others. *Judicial liens* are liens created by courts. They include execution liens, judgment liens, attachment liens, and in most states, garnishment liens.

Liens of all types confer essentially the same rights — the rights to have the property sold and to be paid from the proceeds. When property is subject to two or more liens, legal rules will specify who has *priority*. A "senior" lien is entitled to be paid or provided for in full before a "junior" lien is entitled to any payment at all. If a widget worth $15,000 is subject to three $10,000 liens, the lien with first priority will be paid in full, the lien with second priority will be paid $5,000, and the lien with third priority will be paid nothing.

A security interest can prioritize not only a debt, but any legal right that carries a damage remedy. That is, unilaterally granting a security interest to the holder of one unsecured right gives that holder priority over the holders of all other unsecured rights. As a result, security interests and liens are fundamental to all deal making, from divorce settlements to corporate mergers. By determining whose legal rights have priority, security determines who has privilege and power. Security's effects are present even if the obligation is never in default. Anyone who has taken out a mortgage on a home or signed a security agreement to finance a car will know what we mean.

Most secured creditors obtain their rights by contract. Those private contracts—*security agreements*—bind the parties who sign them. In addition to establishing the legal rights of the debtor and creditor, the security agreement is effective against third parties. For example, Uniform Commercial Code §9-201 provides that "Except 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." Security is an agreement between A and B that C take nothing.

The idea of a private contract that binds non-parties is, for most of us, startling. Defenders analogize security agreements to real estate conveyances. They argue that, by granting a security interest, the debtor conditionally sells the collateral to the extent of the secured obligation. (Quite a mouthful, isn't it?) They also note that the Uniform Commercial Code requires the parties, in most instances, to provide "notice to the world" of the agreement's existence by making a UCC filing. (What? You've never heard of the UCC filing system? Your legal rights have been affected by this system since before you were born. When you make certain purchases, you are charged with the knowledge that the system would have provided—if only you had known to look.)

The concept of security permeates the law. This book explores the use of that concept across numerous bodies of law, but the emphasis is on Article 9 of the Uniform Commercial Code. We have tried to write this book so that its five major topics can be covered in any order. Those topics are (1) remedies, (2) creation of security interests, (3) default, (4) perfection, and (5) priority. Regardless of the order in which you cover them, we think you will find the following overview helpful.

The book has two parts. Part One deals with the relationships between a debtor and a secured creditor. Part Two deals with competitions among secured creditors and a variety of other parties who may claim collateral.

Part One begins with remedies—the consequences of secured credit. Under state law, secured creditors have the right to force sale of the debtor's property after default and have the sale proceeds applied to the obligation. Debtors generally remain liable for any unpaid balances—called "deficiencies"—remaining after application of the sale proceeds.

An unsecured creditor can become a secured creditor by obtaining a judgment on the debt, obtaining a writ of execution based on the judgment, and then levying on specific property of the debtor. The "levy" occurs when a sheriff or other public official takes possession of the property. From the moment of levy, such a creditor is referred to as a "lien creditor." Becoming a lien creditor by levy is a relatively ineffective remedy because (1) creditors who obtained secured status by contract when they loaned money to the debtor will have established their rights earlier and have priority over the lien creditor, (2) some creditors who obtained secured status by contract have self-help repossession rights not available to unsecured or lien creditors, and (3) the rights of lien creditors, but not those of creditors who obtained secured status by contract, are subject to exemption laws.

Because most foreclosure and execution sale procedures are antiquated and ineffective, collateral often sells for substantially less than it is worth. Article 9 takes a different approach. It authorizes the secured creditor to conduct the

sale. Instead of specifying procedures for sale, Article 9 requires that every aspect of the sale be commercially reasonable and leaves it to the secured creditors to devise the procedures.

When a debtor files bankruptcy, creditors are automatically stayed (enjoined) from exercising their remedies. Secured creditors are entitled to adequate protection against decline in the value of their collateral during the bankruptcy case and to relief from the stay if the debtor can't provide adequate protection. Ultimately, secured creditors are entitled to the value of their collateral, up to the full amount the debtor owes them. Unsecured creditors are not entitled to adequate protection of their expectancies or to relief from the automatic stay. Instead, they receive what remains after provision for or payment of secured creditors.

Part One then turns to the creation of security interests. The debtor and the creditor create a security interest by entering into a "security agreement." A security interest is said to "attach" to the collateral when the last of three events has occurred: (1) the debtor has signed a security agreement that provides a description of the collateral, (2) the secured creditor has given "value," usually by disbursing loan proceeds, and (3) the debtor has acquired rights in the collateral.

When a debtor sells or otherwise disposes of collateral, two important rules apply. First, a security interest granted by that debtor-seller generally continues in the collateral in the hands of the buyer. Second, the security interest attaches to the sale proceeds.

The first rule has numerous exceptions. The most important is that a buyer in the ordinary course of the seller's business takes free of any security interest the seller created. For example, someone who buys restaurant equipment from a restaurant equipment dealer takes free of a security interest in favor of the dealer's inventory lender, but someone who buys restaurant equipment from a restaurant does not take free of a security interest in favor of the restaurant's equipment lender.

A security interest granted by the debtor-seller attaches to the proceeds in either type of sale. To illustrate, if a restaurant sold unneeded restaurant equipment for $90,000 in cash, the restaurant's bank lender might have a security interest in both the equipment in the hands of the buyer and the $90,000 in the hands of the seller.

A security agreement may provide that property the debtor acquires in the future will be collateral. Such an "after acquired property" clause will cease to be effective when the debtor files bankruptcy. But even during bankruptcy, security interests continue to attach to proceeds.

Bankruptcy courts have the authority to limit a secured creditor's proceeds "based on the equities of the case." A classic example of the equities-of-the-case exception occurs in inventory lending. Suppose a restaurant equipment dealer is in bankruptcy. The dealer buys equipment wholesale for $50,000 and sells it at retail for $90,000. A bankruptcy court might use the exception to limit the inventory lender's interest in the $90,000 of proceeds to $50,000. The court might reason that the $40,000 difference represents the debtor's contribution of value by advertising the equipment for sale, paying the salesperson's wages, providing the retail floor space, and paying other expenses of the sale.

Law and policy limit the types of property that may be collateral. Excluded items include individuals' future earnings, pension rights, some kinds of licenses and franchises, certain low-value consumer goods, and human body parts before their removal.

The last topic in Part One is default. Generally, a creditor may exercise remedies only when the debtor is in default. After default, if the loan agreement so provides, the creditor may "accelerate" payment by declaring future payments immediately due and payable. Under state law, a debtor can generally cure a default, but cannot reverse an acceleration. Under bankruptcy law, a debtor may be able to reverse an acceleration by proposing and obtaining court confirmation of a repayment plan.

Part Two of the book begins with a simple description of priority. Priority is a right to be provided for, or paid from, the value of the collateral before other creditors are paid anything at all. Generally speaking, the first creditor to "perfect" its security interest or lien by giving public notice in a manner authorized by law has priority.

The most commonly authorized manner for giving notice of a security interest or lien is to file the notice in the appropriate filing system. Future lenders can discover the existence of prior liens by searching the appropriate filing system before making their loans. After the debtor repays the obligation, the notice can be cancelled by filing a satisfaction or termination statement.

If the notice is in a form authorized by Article 9, the notice is called a "financing statement." For most kinds of collateral, financing statements are effective for only five years but can be extended by filing "continuation statements."

Filing and searching in the Article 9 filing systems are by debtor's name. Filings are ineffective unless made in the debtor's correct name or a name sufficiently similar that the filings will show up in a search under the correct name. Article 9 filings also include the parties' addresses and a description of the collateral to make it easier for searchers to recognize relevant filings. Filing and searching in other filing systems may be by the debtor's name or by a number—such as a real estate tract number or the VIN number that identifies an automobile.

Secured parties can use two other methods of perfection: taking possession of tangible collateral or taking "control" of intangible collateral. For some types of collateral, these methods are merely permitted, while for other types they are required. In addition, some security interests and liens are automatically perfected without the secured party providing any notice to future lenders.

Security interests in real property—called "mortgages" or "deeds of trust"—are perfected by recording in county filing systems. Mortgages encumber not just land and buildings but also encumber property affixed to land or buildings ("fixtures"). Security interests in fixtures can also be perfected by filing Article 9 financing statements in the real estate or Article 9 filing systems.

The appropriate manner of perfection may depend on the type of collateral, the manner in which the collateral is used, the name of the owner, the location of the debtor, or the location of the collateral. If these conditions change between the time of filing and the time of searching, a searcher may be unable

to discover a prior lender's notice. In response to some condition changes, the prior lender must conform its notice to the changed condition by some statutory deadline. In response to others, the later lender must discover the change on its own.

The last subject covered is priority. Creditors with differing priorities in the same collateral may foreclose in any order. They may do so against all or any portion of their collateral, unless their choice would unfairly damage a subordinate lien holder. Any creditor's sale discharges the lien under which the sale is held and all subordinate liens. The proceeds of a sale are distributed to the lien under which the sale is held and all subordinate liens. Prior liens continue to encumber the collateral in the hands of the buyer.

Bankruptcy can alter three key principles of the secured credit system. First, bankruptcy's "automatic stay" can delay foreclosures by senior liens to protect the interests of junior liens and unsecured creditors. Second, the bankruptcy courts can sell collateral free and clear of liens in some circumstances. The proceeds of sale are distributed in accord with nonbankruptcy priorities. Third, the bankruptcy courts can grant new liens with priority over existing liens, conditioned on "adequate protection" of the existing lienors' interests. In addition, if a preexisting creditor improves its priority position in the period immediately prior to bankruptcy, either by becoming secured, or if already secured, by receiving additional collateral, the trustee in bankruptcy or debtor in possession can avoid the improvement.

The remainder of this book examines the competitions among particular kinds of liens and interests in collateral. They include security interests, purchase-money security interests, future advances, real estate mortgages, execution liens, trustees in bankruptcy, sellers, buyers, and statutory liens including federal tax liens. The rules that determine priority between parties in these categories are spread among several different bodies of law. Most operate by assigning a priority date to each of two contestants based on the circumstances of the particular case and awarding priority to the one with the earlier date.

We have written this book with an attitude. Legal education has a way of taking simple things and making them seem complex. In this book we have made every effort to do the opposite — to make this complex, technical subject as simple as possible. This is a course for second- and third-year students who have already mastered reading cases. The threshold intellectual task here is to read statutes; the ultimate intellectual task is to see how law functions together with other elements as a law-related system. Someone who masters that task can see law with new eyes — can see better whom law helps, whom it hurts, what implications it has for planning and transactional work, and how it can be manipulated, for better or for worse, to produce unexpected outcomes.

To make the whole more understandable, we have throughout this book regarded secured credit as a system, with subsystems that work together to accomplish the system's principal goal. That goal is to facilitate credit extensions and deal-making without sanctioning injustice.

To the extent the system succeeds in doing that, it does so in two ways. First, it provides secured creditors with a coercive remedy — repossession and resale of collateral — that does not destroy too much of the value of the collateral in

the process. The existence of a coercive remedy encourages debtors to pay voluntarily. The principal subsystems that provide this remedy are:

1. *Procedures for creating security interests.* This subsystem consists of laws, forms, and rituals used by debtors and their creditors to elevate claims to secured status.
2. *Rules authorizing self-help.* UCC §§9-607 and 9-609 authorize secured creditors to repossess collateral and redirect their debtor's incoming payments to themselves, all without judicial process.
3. *State remedies system.* State governments provide systems by which government officials declare foreclosures, repossess collateral, and sell the collateral for the benefit of secured creditors. All of this is accomplished pursuant to judicial orders and procedures established by law.
4. *Bankruptcy system.* The federal government provides a bankruptcy system in which bankruptcy judges, bankruptcy trustees, and other officials ensure the preservation of secured creditors' collateral while the debtor continues to use the collateral or the bankruptcy officials liquidate it. While these bankruptcy procedures overlap and duplicate those of the older state remedies system, they are less rigid and therefore more effective than those of the state remedies system.

The second manner in which the secured credit system facilitates credit extension is by letting lenders know, before they commit, what priority or rights in the collateral they will have against third parties in the event of default. Here, three subsystems are at work:

1. *Public record systems.* Federal, state, and local governments operate thousands of public record systems in which various kinds of secured parties are required to "file" or "record" their interests to perfect them. The records in these systems are indexed by public officials and then searched by later lenders who seek to discover the security interests, if any, that will have priority over the ones they themselves plan to take.
2. *Rules of priority.* State law, including Article 9 of the Uniform Commercial Code, mortgage law, and thousands of statutory lien laws, contains rules intended to govern priority in competitions between particular kinds of claimants to collateral. Federal law provides additional rules of priority in the areas of bankruptcy, taxation, patents, trademarks, copyrights, admiralty, and others. These rules are interpreted, reconciled, and enforced in state, federal, and bankruptcy courts and, of course, in private negotiations between competing parties.
3. *Bankruptcy lien avoidance.* Secured creditors frequently fail to satisfy the complex technical requirements to perfect their interests. These failures result in relatively few challenges by competing creditors. Bankruptcy law fills the gap by appointing a person to serve as "trustee" in the bankruptcy case, arming that person with the rights of a hypothetical aggrieved lien creditor and providing incentives for the trustee to challenge any security interests that were not perfected properly. From a systems perspective, the effect is to greatly increase the level of enforcement

and contentiousness in the system. That in turn increases the incentives for secured creditors to comply with the technicalities of the system, as well as providing jobs for lawyers.

As may already be apparent, the systems approach we employ in this book looks at more than just law. Law is one of the many elements that together constitute the secured credit system. To teach the law without teaching the system in which it is embedded would deprive the law of much of its meaning and make it more difficult to understand. But to teach the whole system requires discussion of institutions, people, and other things that are not "law." Among them are sheriffs, bankruptcy trustees, filing systems, security agreements, financing statements, search companies, Vehicle Identification Numbers, closing practices, and a variety of other commercial and legal practices. Together with law from a variety of sources, these things constitute the system we know as secured credit and the subject of this course. If you would like to know more about the systems approach, see Lynn M. LoPucki, The Systems Approach to Law, 82 Cornell L. Rev. 479 (1997) and Lynn M. LoPucki & Andrew Verstein, The Systems Approach to Teaching Business Associations, 2020 Mich. St. L. Rev. 703 (2020).

Article 9 of the Uniform Commercial Code (the UCC) constitutes much of secured transactions law. The American Law Institute (ALI) and the Uniform Law Commission (ULC) jointly draft and promulgate the UCC. The ALI is a non-profit organization composed of judges, law professors, and lawyers that also writes the Restatements of the Law. The ULC is a non-profit organization composed of "commissioners" appointed by the states. The Official Text of the UCC is just a recommendation to the states. The UCC does not become the law of a state until the state adopts it. All 50 states have adopted the UCC, but some states have also adopted nonuniform amendments. Because these amendments can be outcome determinative, lawyers generally work not with the UCC, but with the version or versions adopted by the relevant state or states.

The ALI authorizes certain of its officers and members to draft, promulgate, and revise "official comments" to the UCC. The process for approving them is informal and not transparent. The comments are not enacted and do not become law. Courts, nevertheless, often defer to them.

The Uniform Law Commission revised Article 9 extensively in 1998, effective in 2001. Minor changes have been made more recently.

We have heavily edited the cases in this book. To ease readability, we have not marked our omissions with ellipses. In each instance we have tried to be faithful to both the letter and spirit of the original.

We have tried to include in each assignment all of the information needed to answer the problems at the end. The problems in a set are presented roughly in the order of their difficulty. The most difficult problems are in practice settings. Many of them are sufficiently complex to challenge even lawyers who have been practicing commercial law for many years. Our assumption is that each member of the class, working alone or perhaps with one or two others, will find a satisfying solution to each problem before class. In class, students will present and discuss a variety of solutions and then attempt to settle on one

or two that seem best. The process is not unlike that followed in most large law firms when several lawyers meet to brainstorm and formulate case strategy. Like most lawyers, we think that such sessions are the most challenging, intellectually exciting, and fun parts of law practice.

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I don't know as I want a Lawyer to tell me what I cannot do.
I hire him to tell me how to do what I want to do.

—J. P. Morgan