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Beth A. Diebold

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RECENT LEGISLATIVE ACTIVITY

Beth A. Diebold

The Expanding Concept of Security Interests: An Introduction to Revised UCC Article 9

I. Introduction

Suppose you restored antique cars for a living, and owned several that were ready for sale. You might deliver them to an independent dealer, requesting the dealer to sell the cars for you for a specified price in exchange for a percentage of the proceeds. The dealer might consent to this, and agree that if the cars could not be sold by a certain date, he would return them to you. At that point you would have an interest in the cars to secure payment in the event of sale, or to secure their return if no sales occurred. However, would your interest be legally recognized?

Suppose you discovered several months later that the dealer was unable to sell your car and had in fact filed for bankruptcy? Could you lawfully return to the dealer at that point and simply drive the car back to your garage? The answer might appear to be a simple "yes." After all, the car *does* belong to you, doesn't it? And the dealer *did* agree to return it if it wasn't sold, didn't he?

Unfortunately, the answers to the questions above are not as simple as they seem. In addition, today's answers may not be the same as they will be on July 1, 2001. On that date, various changes will be available for adop-

tion by the states regarding UCC Article 9, a series of provisions that regulates certain types of sales and exchanges.

Transactions involving the use of collateral to secure payment for goods or services are known as secured transactions and are governed by UCC Article 9. Recently, extensive revisions to Article 9 were approved by both the American Law Institute and the National Conference of Commissioners on the Uniform State Laws and submitted to the states for adoption. This article will outline the concept of a secured transaction, briefly describing both the concept of a security interest and those types of transactions in which a security interest is formed under current Article 9. It will then explain some of the reasons behind the Article 9 revisions. Technological developments as well as an expanding economy have greatly increased the need for legally-recognized secured transactions in a variety of different areas and have caused many of the current Article 9 provisions to become obsolete. Revised Article 9 contains provisions which both update procedures and expand the scope of transactions that may be subject to a perfected security interest. In addition, Revised Article 9 provides guidance intended to resolve several disputes that have been caused by ambiguous language in the current Article 9. While the forthcoming revisions increase the number of different transactions that will be governed by Article 9, it has been the intent of the drafters to simultaneously simplify its provisions. Ideally, the revisions will allow greater access to Article 9 protections with fewer complications.

II. Defining the Secured Transaction

According to its own provision, Article 9 of the Uniform Commercial Code ("UCC") has as one of its major purposes the regulation "of any transaction. . . which is intended to create a security interest in personal

property or fixtures. . . ."¹ A security interest is sometimes referred to as a consensual lien, because it is a claim to property that arises only upon the consent of the parties to the transaction.² Where parties consent to the creation of a such a security interest, the resulting agreement is known as a secured transaction, which is the focus of both Current and Revised Article 9.

Generally, a secured transaction involves two primary parties, including a debtor and a secured party. Current Article 9 defines the debtor as the individual who "owes payment or other performance on the obligation secured."³ The secured party is usually a lender or seller who, upon granting a loan or a sale on credit to the debtor, obtains a security interest in personal property or fixtures belonging to that individual to secure the amount or obligation owed.⁴ Property that is used to secure repayment is known as collateral.⁵ UCC Article 9 provides both debtors and creditors with certain rights in collateral when that collateral is held subject to a valid, legally-recognized security interest.

III. Why Revise?

Revised Article 9 retains the basic structure of the current provision, focusing on the wide variety of consensual security interests in personal property and fixtures and the appropriate means of perfecting each.⁶ However, there are 36 new sections that have been added to Revised Article 9 that have no counter-parts whatsoever in the current provisions. These new sections serve both to expand the scope of transactions that are covered by Article 9 as well as to simplify the creation and perfection of Article 9 security interests.⁷ With respect to the volume of completely new material that will be incorporated into Revised Article 9, some have suggested that it might be more accurate to label the 1998 version as "new," rather than merely "revised," for not only does the latest version include selective amendments, it is a

completely “reorganized, renumbered and rewritten Article.”⁸

A. Accommodation of Technological Changes

One purpose of the revisions has been to update the Article, allowing it to remain current with technological changes that have occurred in the area of financial transactions. Revised Article 9 modifies a number of old sections and adds several new provisions that permit collateral in the form of technology or rights to technology, provide for the creation of electronic security agreements and regulate electronic filings.⁹

Chattel paper, for example, is a type of collateral consisting of a monetary obligation together with a security interest in or a lease of specific goods where the obligation and the security interest or lease are evidenced by “a record or records.”¹⁰ The definition is expanded in the Revision to include a monetary obligation together with a security interest in or a lease of specific goods and software (or license of software) used in the goods, thereby expanding the forms of collateral which may be encompassed in chattel paper.¹¹ In addition, Revised Article 9 formally recognizes electronic chattel paper, defining it as “chattel paper evidenced by a record or records consisting of information stored in an electronic medium.”¹² According to Official Comment 5 of Revised §9-102, “the concept of an electronic medium should be construed liberally to include electrical, digital, magnetic, optical, electromagnetic, or any other current or similar emerging technologies.”¹³

One revised Article 9 provision grants a purchaser of chattel paper who takes possession of the document priority over an existing creditor who has an interest merely in the proceeds of such collateral, provided that certain conditions are met.¹⁴ The drafters have allowed the same provision to apply where the chattel paper is reduced to an electronic form by requiring the purchaser

to take "control" of the collateral.¹⁵ Control of electronic chattel paper is governed by Revised §9-105, a completely new addition to the Article 9 provisions that strictly addresses security interests in electronic chattel paper.¹⁶ Revised §9-105 sets out requirements for how an individual may obtain control in such an instance, and includes, among others, the mandate that a single authoritative copy of the record exist that is unique, identifiable and generally unalterable.¹⁷ Revised §9-105 establishes only what is required for control of electronic chattel paper. The drafters have left the business of developing systems and procedures for implementing such measures to practitioners.¹⁸

Several provisions have also been added to facilitate electronic filing for the perfection of security interests. For example, under Revised §9-509, an individual may file a financing statement only if the debtor authorizes the filing in an "authenticated" record.¹⁹ Official Comment 9(b) to Revised §9-509 indicates that the term "authenticate" has generally replaced the term "sign" in the current provisions in order to encompass the filing and transmission of both tangible and intangible records.²⁰ Revised Article 9 indicates that authentication is accomplished by signing or by executing, encrypting or similarly processing a record with the present intent of the authenticating individual to adopt or accept the record.²¹ In addition, a debtor's act of authenticating a security agreement automatically authorizes the filing of a finance statement.²² Consequently, where an individual filing a finance statement can produce an authenticated security agreement, the finance statement is considered to be valid whether or not it has been signed by the debtor, as long as all other necessary information is present.²³

B. Resolution of Disputes Over Current Article 9 Language

In addition to facilitating the use of electronic

media, the Article 9 revisions have also enabled the drafters to resolve certain legal disputes that have arisen over the interpretation of various prior provisions.²⁴ One question which has divided various courts concerns the extent of the description of collateral that is required in both the financing statement and the security agreement.²⁵ Currently, a financing statement may identify collateral by referring to its classification under Article 9 or simply by a description of the item.²⁶ A security agreement is required to indicate the collateral involved using "a description" only.²⁷ One problem that has arisen from these requirements is an inability of the courts to uniformly determine the extent of specificity that should be included in a required description of collateral. Because the provisions are somewhat vague with respect to what exactly must be present, some courts have accepted very broad descriptions of collateral such as "all consumer goods" or "all personal property" as being specific enough to allow identification of the thing described, while others have not.²⁸ Revised Article 9 provides some guidance in this area, particularly with respect to consumer transactions.²⁹ First, Revised Article 9 actually provides examples of acceptable descriptions, including the identification of collateral by specific listing, category and/or quantity, among other methods.³⁰ Supergeneric descriptions of collateral such as "all the debtor's assets," or "all the debtor's personal property" are specifically disallowed.³¹ In addition, Revised Article 9 disallows description of collateral according to its UCC category in any consumer transaction or transaction involving consumer goods, in order to prevent debtors from inadvertently encumbering certain property.³²

A second dispute that has specifically been addressed by the drafters of the revisions involves the applicability of Article 9 to security interests in notes secured by real estate. Current Article 9 already indicates that the Article does, in fact, cover such transactions.³³ However, beginning with *In re Maryville Savings and Loan*

Corp., a line of cases developed which rejected this provision.³⁴

Current Article 9 states that the provisions applicable to the perfection of security interests are not applicable to the creation or transfer of an interest in or lien on real estate.³⁵ However, current provisions also state that the application of Article 9 "to a security interest in a secured obligation is not affected by the fact that the obligation is itself secured by a transaction or interest to which this chapter does not apply."³⁶ In other words, although Article 9 is inapplicable to a transaction where a security interest is formed using real estate as collateral, such as in the granting of a mortgage to secure an obligation, its provisions would be applicable where a debtor granted a mortgage to creditor A in the form of a promissory note, and creditor A then used that note to secure a loan from creditor B.³⁷ In such an instance, creditor B would be required to perfect his security interest in the note according to Article 9 provisions.

In *Maryville* and other cases that followed, courts began to hold that a creditor's security interest in a transaction similar to the above was perfected even though the creditor neglected to file because the interest was secured by a real estate mortgage, and Article 9 specifically excludes the creation of a lien on real estate from its scope.³⁸ Although not all courts followed the *Maryville* line of cases, a split did develop among the jurisdictions regarding which interpretation of the provision was the correct one.

Revised Article 9 merely re-states the language in Current Article 9 regarding the applicability of Article 9 to such transactions.³⁹ However, the drafters have included in Official Comment 7 to Revised §9-109 an example of the transaction in dispute and a specific explanation of how Article 9 is in fact applicable in such a situation.⁴⁰ Finally, Official Comment 7 to Revised §9-109 specifically rejects the holding in the *Maryville* line of cases.⁴¹

C. Expanding the Scope of Transactions Covered by Article 9

Perhaps the most significant change in the Article 9 Revision is the expanded scope of transactions that may now be classified as Article 9 Secured Transactions. Some transactions which currently fall outside the provisions but which will soon be covered by Article 9 include the sale of "payment intangibles" and promissory notes, as well as consignments.⁴²

Although a sale which does not appear to be on credit might seem to fall outside the general outline of a secured transaction, certain sales are still governed by Article 9 because the purchaser does not immediately receive value for his purchase. When such sales occur, it is difficult to distinguish between transactions in which a receivable secures an obligation and those in which the receivable has been sold outright. Consequently, the drafters have chosen to treat all such transactions, even when they are sales, as Article 9 security interests.⁴³ A sale of accounts, which involves the sale of rights to payment, is one example of a this.⁴⁴

An individual who purchases accounts purchases a right to receive value that is originally owed the seller. In other words, the purchaser of accounts gives value to the seller in exchange for a future right to value which is owed to the seller of the accounts, thereby transferring the risk of non-payment to the purchaser herself. For this reason, a purchaser of accounts is known as an Article 9 secured party, and a seller of accounts an Article 9 debtor.⁴⁵

When an individual purchases a promissory note, defined as an instrument evidencing a promise to pay a monetary obligation, she is also purchasing a promise of future payment that is originally owed to the seller of the note, again thereby transferring the risk of non-payment to herself.⁴⁶ For this reason, the sale of a promissory note will be considered a secured transaction under Revised

Article 9.⁴⁷ Revised Article 9 will hereafter govern the sale of "payment intangibles," defined as general intangibles under which the account debtor's principle obligation is a monetary obligation, for similar reasons.⁴⁸

Consignments are another category of transactions that will soon be considered Article 9 secured transactions. Consignments, traditionally defined as bailment procedures in which a consignor delivers goods to a consignee for sale to the public, have historically been governed by Article 9 provisions only in specified cases.⁴⁹ Currently, analysis of the circumstances surrounding the transaction is necessary in order to determine whether a consignment falls within the scope of Article 9. If the consignment is determined to be governed by Article 9, the consignor must take steps to perfect his security interest in the consigned goods or he risks losing them to other creditors of the consignee. If the consignment is determined to fall outside the scope of Article 9, and all the necessary requirements are met, however, the consignor, called a "true consignor" in this instance, is allowed to prevail over competing creditors of the consignee with respect to his own goods.⁵⁰ In other words, where an individual is considered a true consignor, he is entitled to certain rights in goods of his possessed by a consignee even though he does not possess an Article 9 security interest.

Under the revised provisions, however, all consignments regardless of their form will be covered by Article 9.⁵¹ The Revised Article 9 definition of a "consignment" is a slightly altered version of that present in Current Article 9. Revised §9-102(20) defines a consignment as a transaction involving, among other requirements, goods which are not consumer goods immediately before delivery and goods the value of which exceeds \$1,000.⁵² Consequently, any time a consignor delivers such goods to a consignee for sale to the public, the consignor will be required to take additional steps to perfect his security interest in the signed goods.⁵³

The situation presented in the beginning of this article is an example of a consignment which might very likely fall outside of the current Article 9. If all that existed between a consignor and a consignee was a document detailing the agreement, yet other requirements were met under U.C.C. Article 2, such as compliance with a state sign law or general knowledge that the consignee frequently engaged in sales on consignment, a consignor might be well within her rights to simply drive the cars off the lot and back to her garage. However, if Revised Article 9 controlled the above transaction, and the consignor had not taken steps to perfect a security interest in the cars, she would risk losing her property to the dealer's other creditors under revised §9-109, *despite the fact that the consignor owned the cars*. Under Article 9, the consignor would not hold a perfected security interest in such a situation and would not be granted priority with respect to the value owed her by the debtor.

IV. The Final Step

While Revised Article 9 retains the basic concept of a security agreement present in the current chapter, it develops the notion further by expanding its scope, affording the legal protection of a security interest to a greater number of transactions. The Article 9 revisions should serve to simplify the creation and perfection of security interests by imposing fewer and less tedious restrictions on the process and by allowing it to proceed electronically. Nonetheless, implementing many of the revisions, such as a system regulating the control of electronic chattel paper, discussed earlier in this article, will likely be the source of initial confusion and perhaps even a new body of case law. The job of adopting the provisions as well as supplying administrative foresight designed to head off potential litigation now moves on to the states.

Endnotes

1. U.C.C. §9-102(1)(a) (1995); *See also* Revised ("Rev.") U.C.C. §9-109(a)(1) (1999).
2. DOUGLAS J. WHALEY, *PROBLEMS AND MATERIALS ON SECURED TRANSACTIONS 2* (4th ed. 1997).
3. U.C.C. §9-105(1)(d) (1995); *See also* Rev. U.C.C. §9-102(a)(28) (1999).
4. *See* U.C.C. §9-105(1)(m); *see also* Rev. U.C.C. §9-102(a)(72). "Fixtures" are items of personal property that are affixed to real property so as to become a part of the real property itself. BLACK'S LAW DICTIONARY 638 (6th ed. 1990). *See also* U.C.C. §9-313(1)(a) (1995). Examples of fixtures include heating/air-conditioning systems, alarm system, sprinklers and emergency lighting systems that may be installed in homes or buildings.
5. *See* U.C.C. §9-105(1)(c); Rev. U.C.C. §9-102(a)(12).
6. Edwin E. Smith, *Overview of Revised Article 9*, 73 AM. BANKR. L.J. 1, 2 (1999).
7. *See id.*
8. MATTHEW BENDER & COMPANY, *UNIFORM COMMERCIAL CODE ANALYSIS OF REVISED ARTICLE 9, 1* (1999).
9. *See* Rev. U.C.C. §9-102(a)(31).
10. U.C.C. §9-105(1)(b).
11. *See* Rev. U.C.C. §9-102(a)(11).
12. Rev. U.C.C. §9-102(a)(31).
13. *Id.*
14. Rev. U.C.C. §9-330(a) (1999).
15. *Id.*
16. *See* Rev. U.C.C. §9-105 (1999).
17. *See id.*

18. *See* Rev. U.C.C. §9-105 Official Comment 4.
19. Rev. U.C.C. §9-509(a) (1999).
20. *See* Rev. U.C.C. §5-509 Official Comment 9.
21. *See* Rev. U.C.C. §9-102(a)(7).
22. *See* Rev. U.C.C. §9-509(b).
23. *See* Rev. U.C.C. §9-509 Official Comment 2.
24. MATTHEW BENDER & COMPANY, *supra* note 8 at 2.
25. *See* *In re Turnage*, 493 F.2d 505, 14 U.C.C. Rep. Serv. 1051 (5th Cir. 1974); *See also* *In re Fuqua*, 461 F.2d 1186, 10 U.C.C. Rep. Serv. 936 (10th Cir.1972).
26. *See* U.C.C. §9-402(1) (1995).
27. *See* U.C.C. §9-203(1)(a) (1995).
28. *See In re Turnage*, 493 F.2d at 506.
29. *See* Rev. U.C.C. §9-108 (1999).
30. *See id.*
31. *See id.*
32. *See id.*
33. *See* U.C.C. §9-102(3) (1995).
34. *See In re Maryville Savings & Loan Corp.*, 743 F.2d 413 (6th Cir. 1984).
35. *See* U.C.C. §9-104(j) (1995).
36. *See* U.C.C. §9-102(3).
37. *See* Rev. U.C.C. §9-109 (1999) Official Comment 7.
38. *See In re Maryville*, 743 F.2d at 415.

39. *See* Rev. U.C.C. §9-109(b).
40. *See* Rev. U.C.C. §9-109 Official Comment 7.
41. *See id.*
42. *See* Rev. U.C.C. §9-109(a)(3); *see also* Rev. U.C.C. §9-109 Official Comment 4.
43. *See id.*
44. *See id.*; *See also* U.C.C. §9-102(1)(b).
45. *See* Rev. U.C.C. §9-102(a)(72, 28); *See also* U.C.C. §9-105(1)(d, m).
46. *See* Rev. §9-102(a)(65).
47. *See* Rev. §9-109(a)(3).
48. *See* Rev. §9-102(a)(61).
49. *See* BLACK'S LAW DICTIONARY 306 (6th ed. 1990).
50. *See* U.C.C. §2-326(3) (1994).
51. *See* Rev. §9-109(a)(4) (1999); *See also* Rev. §9-109 Official Comment 6.
52. *See* Rev. 9-102(20).
53. Revised Article 9 also includes revised definitions for the terms "consignor," and "consignee." The practitioner who may potentially be involved in consignment transactions is advised to make a note of the changes. *See* Rev. U.C.C. §9-102(19, 21).

