

Overview

This these course materials focus on secured transactions, with an emphasis on security interests in personal property (as opposed to deeds of trust and mortgages on real property). Most of the security interests studied are governed by Article 9 of the Uniform Commercial Code. Depending on the type of collateral at issue, Article 9 specifies different methods to obtain and perfect a security interest. However, Article 9 also contains significant exceptions for many valuable classes of personal property collateral (such as insurance contracts, certain types of intellectual property, aircraft and vessels, to name but a few exceptions). Accordingly, the materials introduce students to various important exceptions to coverage by Article 9, as well as studying the different procedures for collateral subject to Article 9. You should note that, in addition to coverage under Article 9, you must study Article 8 for coverage of certain types of investment property. Study of Article 8 has the additional benefit of introducing you to various subject matter covered on the corporation law portion of the bar exam which is rarely covered in a business associations class.

The materials also discuss alternate methods that creditors use to assure payment from debtors, including corporate structure, guarantees and subordination agreements—all voluntary arrangements created by contract. You will need to understand these alternate methods to fully appreciate the structure of covenants in real world credit agreements and other loan documents. Additionally, the law provides protections for certain classes of creditors by creating “statutory liens” in their favor; the materials also provide examples of these non-consensual protections for creditors which compete with security interests.

Any study of secured transactions necessarily intersects with a study of insolvency laws (particularly the United States Bankruptcy Code) because, when a debtor is unable to repay its creditors, the debtor often seeks protection under the Bankruptcy Code or similar state insolvency laws. Significantly, often creditors obtain security interests specifically to protect their financial interests should their debtors seek court protection in insolvency proceedings. These materials introduce students to some key concepts under the Bankruptcy Code (principally, the automatic stay, preferential transfers and fraudulent transfers)—though the detailed investigation of insolvency law requires further study beyond the scope of these materials.

Key Legal Concepts

The law of secured transactions builds upon basic concepts learned in

introductory contracts and property law courses. Though this course may at times appear intricate with its myriad of details, there are only two main ideas in the entire course. Both of these ideas center on the voluntary agreement of a debtor and a creditor to create a secured transaction as opposed to an unsecured credit transaction.

The creation of a secured transaction changes two basic legal default rules that apply to unsecured loans: (i) first, both criminal and tort laws prohibit one person from taking the property of another person without permission and (ii) second, both state and federal laws provide for the allocation of an insolvent debtor's property among the debtor's various unsecured creditors on a *pro rata* basis determined by the outstanding principal amounts owed to the various creditors.

When the creditor and debtor agree to a secured transaction, these two default rules change. The debtor agrees that the creditor can repossess certain of its property should it default without seeking permission or invoking the judicial process—thus no crime or tort occurs, and the creditor need not go to court. In effect, the security agreement which creates the secured transaction amounts to advance permission for the creditor to seize or otherwise realize value from debtor property to repay a debt. Significantly, this may be done without invoking the judicial process.

And, the existence of the secured transaction gives the creditor the option of publicizing its security interest (known as “perfecting” the security interest)—thus creating a limited interest in property in favor of the creditor—so that the secured creditor will have priority over other creditors and not be subject to the generally applicable *pro rata* distribution scheme provided by generally applicable law. Unperfected security interests do not give the creditor protection against other secured parties, those who hold liens or other unsecured creditors.

In sum, the mere existence of a security agreement creates a two-party **contract** relationship between the creditor and the debtor which allows the creditor to realize on debtor property, without advance permission and without violating tort or criminal laws. This benefit accrues to the secured creditor whether or not the creditor **perfects** its security interest to make it applicable to third parties. If the creditor takes the additional steps needed to **perfect** its security interest by publicizing its existence, then the creditor has converted the secured transaction into a three-party relationship among the creditor, the debtor and the rest of the world. When the creditor has established rights in collateral that are good as against all third parties, it has successfully created a **property** interest. For these reasons, one can accurately say that the study of secured transactions amounts to nothing more than the study of a basic contract law relationship and a basic property law relationship.

Keep in mind that, as a general matter, a creditor may acquire a property interest in debtor property in one of three different ways. First, the creditor may acquire a security interest in debtor property in a voluntary contract transaction by

obtaining a security agreement from the debtor. This gives the creditor rights in debtor property that may be enforced against the debtor, including the right to exercise self-help remedies against the debtor without using the courts. If the security interest is perfected, the creditor may also enforce this security interest against third parties who also might assert claims against debtor property. Second, certain creditors may acquire a lien against debtor property automatically, simply by operation of a statute. Examples of these statutory liens include materialman's and mechanic's liens which arise by operation of law when a contractor does work on your home or a mechanic repairs your car. The law gives these workers a property interest in debtor property automatically to secure repayment owed for materials, parts and labor. The workers may enforce these statutory liens to obtain payment. Third, an unsecured creditor may acquire a judgment lien on debtor property after winning a lawsuit. This entitles the judgment creditor to invoke the court process to collect its debt. If the judgment creditor files its judgment lien (i.e. publicizes it in the proper way), then this judgment lien will be “perfected” and thus provide the judgment creditor with protections against other third party creditors of the debtor (though the court process must still be invoked to enforce the judgment lien).

You should note that the filed judgment lien is inferior to a consensual security interest in at least two different ways. First, the filed judgment lien does not entitle the judgment creditor to exercise self-help remedies. Second, the filed judgment lien arises much later in time—only after a final judgment is obtained following a victory in a lawsuit. The security interest can (and should) be perfected at the start of the transaction—when credit is first extended. This timing advantage can be of enormous significance for at least two reasons: it provides enhanced priority against other creditors; and, it is less likely to be avoided by a bankruptcy court.

As to priority, the general rule is that the priority of liens and security interests arises in the order in which they are perfected. First in time has first in right. Thus, a prior perfected security interest will defeat a later filed judgment lien. As to avoidance, we will study in some detail the ability of a bankruptcy court to avoid security interests and liens which constitute preferential transfers. In general, a bankruptcy court may avoid as a preference any security interest or lien which is created and perfected to secure an antecedent debt shortly before a debtor bankruptcy filing—this happens when a creditor takes a security interest after it has advanced credit and when a judgment creditor files a judgment lien.

Procedures for Collecting an Unsecured Debt

In the absence of a secured transaction, a creditor may not (as a general rule) take the property of its debtor to satisfy or repay an unpaid debt. Such an action

would amount to some form of theft or burglary under the criminal law and would give rise to the tort of conversion under civil law. In the absence of an agreement, this is the default rule that applies. Because of our default criminal and tort law rules, an unsecured creditor must sue the debtor and obtain a judgement. When the unsecured creditor obtains a judgement, the creditor now may use the court system to obtain property of the debtor—typically obtaining a writ that directs the sheriff to levy on property of the debtor to repay the debt. The sheriff, not the creditor, collects the debtor's property. The property on which the sheriff levies may then be sold at auction in a judicially administered sale. Note that the unsecured creditor must engage the legal process in three different ways: first, by filing a lawsuit and obtaining a judgement after a trial; second, by obtaining a writ that directs the sheriff to levy on property of the debtor to satisfy the judgment (note that many debtors will not voluntarily pay a judgment even if the creditor wins the law suit!); and third, by participating in a judicially administered sale of the recovered property to generate funds for debt repayment. Engaging the court system as a remedy thus is both time consuming and expensive. Note that when a creditor wins a judgement, as a matter of law, the creditor obtains a judgement or judicial lien on the debtor's property which it may file to perfect against other third party creditors of the debtor. This creates a property interest in favor of the creditor in debtor property. As a conceptual matter, you might think of this property interest in the form of a judicial lien as forming the basis for the sheriff to levy on the debtor's property and as supporting the filing of the judgment to create a lien that is good against third parties.

Advantages of a Security Interest

However, if a debtor and a creditor enter into a security agreement as part of a loan transaction, these default rules change and the creditor may avoid the need for judicial involvement. Within certain parameters that we will study, the creditor may engage in “self help” if a debtor does not repay a loan. This self help is generally known as “repossession”. A creditor may engage in “repo” activity directly or, more commonly, hires a professional “repo man” to take the property subject to the security interest (known as “collateral”) away from the debtor and return it to the creditor, who is known as the “secured party”. This repo activity is private and does not involve the court or sheriff. A creditor or his repo man may engage in self help so long as the self help does not involve a breach of the peace, and certain other conditions are met. Unlike a judicial lien which applies to the debtor's property generally, a security interest only applies to the specific items of collateral named in the security agreement. Self help may be used to repossess collateral but not other debtor assets. As a general matter, the creditor may keep the repossessed property in satisfaction of the debt or sell the property to raise funds for debt repayment. If the

creditor decides to sell the property to satisfy the debt, the property may be sold without the involvement of the court in administering a judicial sale—though you will see that many rules govern the nature of a permissible privately run sale and whether the creditor may retain property in satisfaction of the debt. These rules are similar to the rules for sale in a court administered proceeding.

Application of the Automatic Stay to All Collection Efforts

You should understand that the security agreement is a powerful tool of contract law that radically expands the remedies available to a creditor by enabling private collection activities which by-pass use of the judicial system. Despite its power and potential convenience, these contract law benefits are radically altered if the debtor files for protection under the Bankruptcy Code due to a provision known as the “automatic stay” of Section 362. When a debtor files for bankruptcy, the mere filing operates as an injunction or order to all creditors to cease private collection activities. To resume these activities, the creditor must apply to the bankruptcy court to obtain relief from the stay. This is sometimes granted (more often not), but it always results in added expense and delay. One of the main reasons a debtor files for bankruptcy is to obtain the relief and protection from collection efforts by creditors that otherwise might take place.

You should note that the automatic stay is broad in its application and will stay collection efforts undertaken by creditors seeking to enforce statutory liens, judgements or the enforcement of those judgments even in the absence of a security interest. An unsecured creditor with a judgement lien is not able to obtain a writ of execution directing a sheriff to levy on debtor property any more than a secured creditor may hire a repo man. All debtor property is converted to a bankruptcy estate under the jurisdiction of the bankruptcy court when the bankruptcy petition is filed. All dealings in property are subject to judicial supervision.

Below is an outline of the procedures for collecting an unsecured debt (designed to mirror Florida law—but generally applicable in all states with minor variations. We will go through the outline, step by step, and fill in applicable Florida statutes by number as we go through the outline. A secured creditor must follow many of the same steps early in the outline. However, those procedures differ when it comes time to file a lawsuit. They further differ (though not as significantly) when it comes time to sell debtor property to generate funds to repay a debt.

An Outline of the Procedures for Collecting an Unsecured Debt

Determine that a debt is due and remains unpaid (note very limited procedures for unmatured debt)

Due at maturity

Due upon acceleration

Automatic acceleration

Bankruptcy events (stop collection—automatic stay—go to bankruptcy court)

Upon notice of acceleration to debtor

Contract interpretation required to ascertain existence of matured default

Issue of materiality of the default

Absence of actual or implied waiver of default by conduct

Lender liability concerns associated with acceleration by creditor notice

Demand note

Notice of demand to debtor

Creditor action in good faith required (subjective vs. objective standard)?

Note due upon creditor determination of insecurity

Notice of demand to debtor

Creditor action in good faith required (subjective vs. objective standard)?

Contact the debtor to obtain payment (or negotiate a settlement, payment plan or waiver, which may include converting an unsecured debt into a secured debt)

Comply with the Federal Fair Debt Collection Practices Act

Applies to consumer debts only?

Applies only to collection efforts by “debt collectors” as defined (and not by the creditor directly)

Comply with the Florida Fair Debt Collection Practices Act (or similar law of another state)

Applies to consumer debts only?

Broader protection than under Federal law—applies to creditor as well as debt collectors

Payment is not forthcoming

Failure to negotiate a waiver of the default or other arrangement acceptable to the creditor

Taking of collateral by an unsecured creditor in exchange for a waiver creates a bankruptcy preference risk

Consider use of limited pre-complaint remedies available to unsecured creditors

Exercise available rights of set-off and recoupment

Exercise right of an unpaid seller to reclaim goods under the UCC for which payment is due

In the case of credit sales

In the case of returned checks (i.e. NSF checks/bounced checks)

File a lawsuit (service of process, complaint, personal jurisdiction)

Confess a judgment under a *cognovit* note (not available in Florida for Florida law governed notes)

Obtain a default judgment (a lucky outcome for the creditor; usually only found in consumer cases)

Go to trial (discovery, jury selection (maybe), trial)

Consider use and applicability of provisional writs prior to judgment/before a judgment is final (limited availability)

Writ of attachment (for personal property in possession of debtor)

Writ of pre-judgment garnishment (for debts owed by third parties to the debtor)

Writ of pre-judgment replevin (for personal property in possession of a third party)

Lis pendens (for real estate in which the debtor has an interest)

Appeals

Possible collateral attacks (e.g. alleged violation of Fair Debt Collection Practices Act)

Final judgment docketed

Procedures for collecting on a final judgment

If the judgment was rendered by a court outside the State of Florida,

domesticate the judgment in Florida or file a new lawsuit based on the extant foreign judgment (the new lawsuit option being rarely used)

For judgments rendered by a court in another state of the United States, use Florida Statute to domesticate the judgment

For judgments rendered by a court in a foreign country, use Florida Statute to domesticate the judgment

File the judgment in the appropriate Florida office to obtain a lien

On personal property file with Florida Secretary of State, Florida Statute

On real property file with the appropriate county recording office, Florida Statute

Obtain discovery in aid of execution, Florida Rule of Civil Procedure 1.560

Obtain a writ of execution (Final Process), Florida Statute

No requirement that a prior notice of lien has been filed with Secretary of State

For use against personal property in the possession of the debtor

Obtain writ from court and deliver writ to sheriff

Sheriff shows writ to debtor and levies on tangible personal property in possession of debtor

Problem of exempt property (exemption hearing?)

Lien created at time of levy on property seized (if lien not otherwise created by filing)

Property held until time of sheriff sale (storage costs)

Publication requirements prior to sale (i.e. advertising sale)

Obtain a post-judgment writ of garnishment, Florida Statute

For use against a third party who owes debtor money (e.g. a bank at which debtor maintains an account; an employer who owes wages to debtor)

Obtain writ from court and deliver writ to third party

Hearing if writ is contested

Problem of exempt property

Federal and state laws which govern wage garnishment

Rules governing Social Security payments

Obtain a post-judgment writ of replevin, Florida Statute

For use against tangible personal property of the debtor in the possession of a third party

Obtain writ from court and deliver writ to third party

Hearing if writ is contested

Commence foreclosure proceedings against real property (details outside the scope of class)

Problem of Homestead exemptions

Equity of redemption

Consider proceedings supplementary, Florida Statute

Alternative to fraudulent transfer action

Consider other equitable proceedings (i.e. turn-over orders) to enhance likelihood of collecting property located both inside Florida and elsewhere and domestication of Florida judgment in other states

Special case of domesticating a judgment in New York to obtain a turn over order for funds in bank accounts even if funds located outside New York State so long as bank has an office or branch in New York [See, e.g. JW Oilfield Equipment, LLC v. Commerzbank, AG, 764 F.Supp.2d 587 (S.D.N.Y. 2011); Koehler v. Bank of Bermuda Ltd. 12 N.Y.3d 533 (2009); but see Shaheen Sports, Inc. v. Asia Insurance Company, Ltd., 2012 WL 919664 (S.D.N.Y. March 14, 2012).]

Sale of Debtor Property

Application of proceeds to sheriff and other costs of sale

Application to repay debt, including interest, etc.

Requirement of contract right to collect attorney's fees

Return of excess to debtor

Filing of notice of discharge of liens/satisfaction of judgment debt

Practical problems that face the unsecured creditor

Transactions costs of the process

Time delays

Court costs

Collection costs (including discovery in aid of execution)

Attorney's fees

Risk of judgment debtor bankruptcy at any point in the process

Automatic stay

Avoidance of judgment liens obtained

Lack of asset value to satisfy the judgment

Debtor has no material assets

Debtor has material assets but they are subject to prior liens and security interests

Debtor has material assets but they are assets exempt from execution and other legal process pursuant to applicable state law