

Secured Transactions
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In the usual transaction involving an extension of credit, the lender will desire to take back a security interest in the property being purchased, other property, or both (collectively called the “collateral”). The purpose of “securing” the transaction is to give the lender certainty that in the event the debtor should default on its loan that not only will the debtor still owe the debt but that the lender may (above most other creditors) seize and liquidate specific property of the debtor to satisfy that debt. Absent the ability to secure debt in this fashion, credit and lending would be less available, the global economy would grind to a screeching halt, and we would likely be living with bronze-age technology. In other words, securing debt is an indispensable tool of modern economics and commerce. So, naturally, there is a great deal of law that has developed over the decades to regulate the securing of debt.

In the United States, the lead body of law on secured transactions is found at Article 9 of the Uniform Commercial Code (aka the “UCC”). That Code has been adopted in each State in some form. But regardless of how each State might have tweaked the language of Article 9, the basic principals remain essentially the same.

To understand how securing debt works though, it is best to start with the premise that an unsecured creditor is a person who has no property rights in its debtor's property. What this means is that if a creditor sells merchandise (a car, a boat, furniture, whatever) to another person (aka the “debtor”), and agrees to be paid at a later time, that creditor becomes an unsecured creditor of the debtor. If the debtor doesn't pay, the creditor has to sue in court to get repaid. The creditor cannot simply go retrieve the merchandise. Otherwise, he or she could face a host of criminal charges ranging from trespass, to burglary to larceny.

By contrast, a secured creditor is a person who has the right to look to specific property to satisfy the debt. Provided the secured creditor has complied with ALL applicable law both to create and to perfect their security interest, they will have the right to reclaim the collateral upon the debtor's default, and the right to sell it to apply the proceeds to the debt.

Also, regarding repossession of the collateral, a secured party can typically recover it without going to court, so long as they do not “breach the peace” while repossessing. Once the collateral is repossessed though, it needs to be foreclosed upon (i.e, sold by private sale or through

the courts), after which, the debtor's rights in the collateral are extinguished and the sales proceeds are applied to satisfy the debt. If the collateral sells for more than the amount of the secured creditor's debt, the secured creditor has to give the excess back to the debtor.

The creation of a security interest begins with a lien created by written agreement (although a signed writing is in certain circumstances not required). Under the UCC, creation of the lien, called "attachment", requires three elements: (1) that the debtor have rights in the collateral; (2) the secured creditor gives value (e.g., extends credit); and (3) either: (a) the security agreement is in writing and the debtor signs it, or (b) the secured party has actual possession of the collateral. Once created though, the secured party is only half way home. He or she still has to perfect it.

Perfection is the giving of public notice of the existence of the security interest in the collateral ('hey, this guy owes me money and if he doesn't pay me I am going to take the following pieces of his property...'). This is done because a properly secured debt also means that other creditors will not be able to look to the collateral to satisfy their debts. So, to keep lending practices fair, the law developed this perfection requirement of public notice.

A security interest can be perfected in three ways: (1) filing a UCC-1 financing statement with the proper public agency (in Arizona, the Secretary of State); (2) recording a copy of the security agreement; or (3) taking possession of the collateral. Which method to use is dependant upon the nature of the debt and type of collateral. So the three methods of perfection should not be regarded as interchangeable. Also, the type of collateral makes a difference as to whether to use an UCC Article 9 security device, or in the instance of fixtures incorporated into real property, for example, whether to use a mechanic's lien to secure payment of the debt.

Although not the simplest of documents for do-it-yourselfers, employing a well-drafted security agreement and then perfecting it can markedly enhance collections and reduce risk in A/R. In some instances, it can also make the difference in getting paid when a customer files for bankruptcy protection. So, with interest rates starting to creep up and foreclosures on the rise, the question to ask is whether you can afford not to start securing the credit you extend to your customers.

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