Welcome to this podcast on Creating a Security Interest – Overview brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is the process by which a creditor attaches a security interest to collateral under Article 9 of the Uniform Commercial Code, thereby making it enforceable by the creditor in the event that there are unmet obligations to the creditor (in most cases by non-payment of a loan by the debtor). This podcast provides an overview of creating a security interest under Article 9 of the Uniform Commercial Code.

Let’s begin with the nature of a security interest. According to § 1-201(35), a security interest “means an interest in personal property or fixtures which secures payment or performance of an obligation.” Most often, though, we are looking at a simple contract that creates an interest in personal property whereby the creditor can foreclose upon default and take possession of the collateral. In the world of real property, we refer to this interest as a mortgage, which is not governed by Article 9.

So, how does a creditor go about creating a security interest to the collateral? In secured transactions, this process is called “attachment.” Section 9-203 states that a security interest attaches to collateral when it becomes *enforceable* against *the debtor* with respect to the collateral. A security interest becomes enforceable only if three elements are present: (i) value has been given (usually the money or goods received in the loan); (ii) the *debtor has rights* in the collateral or power to transfer rights in the collateral to a secured party (meaning some form of property right to the personal property); and (iii) the debtor has signed a security agreement that provides a description of the collateral. When the last of these three things occurs, the security interest attaches and becomes enforceable and the creditor can foreclose if there is a default.

Before looking at examples, let’s discuss the security agreement requirement. The debtor must sign (or otherwise authenticate) a security agreement that provides a description of the collateral (usually meaning a signed security agreement). Notice that § 9-203 only requires the debtor to sign the security agreement and does not require the creditor to sign. A security agreement is simply an agreement whereby the debtor grants to the creditor an interest in the collateral permitting the creditor to foreclose on the collateral if the debtor defaults. It’s the reasonable description of the collateral in the security agreement that tells us which items of the debtor’s personal property are attached by the security interest. It is worth noting that debtors typically also sign a promissory note in which they promise to pay an obligation over time in exchange for the value given by the creditor, but a promissory note itself is typically not the security agreement.

Let’s look at an example.

Example 1. Martin wanted to buy a clarinet for her son Marshall. Music City agreed to sell her the clarinet on credit with Music City using the clarinet as collateral to secure payment of $50 per month over three years. Martin signed a promissory note promising to pay Music City over time for the clarinet and signed a security agreement that granted a security interest in the clarinet to Music City. Music City attached its security interest to the clarinet because: (i) it gave value by providing the loan for the purchase of the clarinet; (ii) the debtor (Martin) had rights to the collateral after Music City sold her the clarinet (she owns it now); and (iii) Martin signed a security agreement that identifies the collateral under the loan as the clarinet. The collateral does not have to be the thing sold. In this example, the clarinet purchased serves as the collateral for the loan, but Martin might have also used something else as collateral, such as a violin she already owns, so long as both parties agree.

While a signed security agreement is a common way to satisfy the third element needed to attach a security interest, there are other alternatives to satisfy the third requirement. Where there is a security agreement, but it is not authenticated (typically because it is an oral agreement), the last element can be satisfied where there is an oral security agreement coupled with three other situations: (i) if the collateral is not a certificated security and is in *possession* of the secured party; (ii) the collateral is a certificated security and in registered form and the security certificate has been *delivered* to the secured party; or (iii) the collateral is deposit accounts, electronic chattel paper, investment property or letters of credit rights and the secured party has *control* pursuant to the debtor security agreement.

Let’s look at two additional examples where an oral security agreement is sufficient.

Example 2. Martin borrowed $1000 from Boltz and promised to repay the loan within six months. Martin gave Boltz a violin to hold until the loan was repaid, but the parties did not sign a written security agreement. Under the rule of § 9-203, Boltz has a security interest in the violin because: (i) Boltz gave value by extending the $1000 loan; (ii) Martin had rights in the collateral as she owned the violin; and (iii) Boltz took possession of the violin subject to an oral security agreement when the parties agreed she could hold the violin until the loan was repaid. Notice that the security interest attached here pursuant to the oral agreement because Boltz took possession of the violin.

Example 3. Music City needed a loan for $10,000 to buy inventory. First Bank agreed to make the loan and Music City orally agreed that the deposit accounts (which is a defined term under Article 9) of Music City at First Bank would serve as collateral for the loan. Under the rule of § 9-203, First Bank attached a security interest in the deposit accounts because: (i) it extended value by disbursing the $10,000 to Music City; (ii) Music City had rights to the deposit accounts because they were in the company name; and (iii) the collateral are deposit accounts and First Bank had control (also a defined term under Article 9) of the deposit accounts (the accounts at First Bank) pursuant to a security agreement. Notice that the security interest attached here pursuant to the oral agreement because First Bank had control of the deposit accounts.

For a security interest to attach under any of these provisions, the *debtor* must agree to the security agreement. Debtor is a defined term under § 9-102 and is typically the person who has an interest, other than a security interest in the collateral. This can be contrasted with the obligor, another defined term under § 9-102, who is the person who owes payment or performance of the obligation. In Example 1 above, Martin was the debtor because she has a property interest in the clarinet (she owns it). Martin is also an obligor because she owes payment under the promissory note she signed. Music City would be the secured party, as it is the person in whose favor Martin created the security interest in the clarinet. Often the debtor and obligor are the same person, but not always.

Example 4. Alicia personally owns sound equipment that she uses in her business, Music City, LLC. Music City needed a loan for $20,000 to purchase additional sound equipment. The new sound equipment will be owned by Music City. Second Bank agrees to make the loan and wants to have a security interest in the existing and new sound equipment as collateral for the loan. Here, both Alicia and Music City would be debtors. Alicia because she owns the existing sound equipment in her personal capacity and Music City because it would own the new sound equipment. Article 9 refers to the debtor as the person who has an interest in the collateral because Article 9 is concerned only with the security interest and not with the underlying obligation.

Under the rule of § 9-203, Second Bank would have a security interest in the sound equipment if: (i) Second Bank gives value by extending the $20,000 loan to Music City; (ii) Alicia and Music City have rights in the collateral (the sound equipment they own); and (iii) both Alicia and Music City sign the written security agreement that identifies the collateral under the loan as the existing and new sound equipment. It is key as a simple matter of contract law that the proper persons are parties to the agreement. Alicia needs to sign the security agreement in her personal capacity because she owns the existing sound equipment. Alicia needs to sign on behalf of Music City because Music City will own the new sound equipment. Music City would also sign the promissory note and be an obligor. If Second Bank does not obtain the signature of Alicia personally on the security agreement, and only her signature as a representative of Music City, it will attach a security interest to the new sound equipment only.

Before concluding, it’s important to note that Article 9 permits secured creditors to take a security interest in many different kinds of personal property. Recall that the security agreement must provide a description of the collateral. Section 9-108 provides that collateral can be described specifically, like a clarinet, generally like musical instruments, or even more generally using categories set forth in Article 9, such as equipment, inventory and accounts. An important limitation on this, however, is that the description cannot be “supergeneric,” such as “all assets” or “all personal property.” It is the specification of the collateral in the security agreement that tells us which items of the debtor’s personal property are attached with a security interest.

At this point, you should be able to describe the process by which a secured creditor could attach its security interest to collateral, thus making it enforceable against the debtor and identify the key elements of attachment: (i) value given; (ii) debtor having rights in the collateral and; (iii) satisfaction of one of the alternative conditions, most often having a security agreement signed by the debtor.

I hope you’ve enjoyed this podcast on Creating a Security Interest – Overview.

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