Welcome to this podcast on Security Agreements brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is when a security agreement is sufficient to enable it to attach 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 is a default by the debtor (in most cases non-payment of a debt). This podcast focuses on the elements of the security agreement required for enforceability of a security interest.

Let’s begin with the nature of a security interest. According to § 1-201(74), a security agreement is a contract “that creates or provides for a security interest.” A security interest is defined in § 1-201(35) as “an interest in personal property or fixtures which secures payment or performance of an obligation.” Most often, we are looking at a simple contract that creates an interest in personal property whereby the creditor can foreclose on the property in the event of default by taking 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 in 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 (most of the time this is the same as consideration -- the money or goods given or promised by the creditor); (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 rights to the personal property); and (iii) there is some proof that the debtor has entered into a security agreement. 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.

Let’s focus here on the security agreement requirement, which can be satisfied in three different ways under § 9-203(b)(3). The first and most common is where the debtor has “authenticated” a security agreement that provides a description of the collateral. The debtor must sign (or otherwise authenticate) a security agreement that provides a description of the collateral (meaning a signed security agreement). The agreement must contain language indicating that the debtor is granting a security interest, though no particular wording is required. Notice that § 9-203 requires only the debtor to sign the security agreement and does not require the creditor to sign. It is the reasonable description of the collateral in the security agreement that tells us which items of the debtor’s personal property the security interest attaches to.

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 the price 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. The security interest attached to the clarinet because: (i) Music City gave value by providing 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 written security agreement that granted Music City a security interest and that identified the collateral as the clarinet.

While a signed security agreement is a common way to satisfy the third element needed to attach a security interest, § 9-203(b)(3) uses the word “authenticated,” which includes signed security agreements, but also would include a security agreement authenticated by a record adopted by electronic sound, symbol, or process. In Example 1, there would be an authenticated security interest if Music City sent Martin a security agreement, and she responded by leaving a voicemail for Music City stating that she agreed to the terms of the security agreement.

There are times when there is not a single document that is clearly a security agreement. As such, courts have created a common law “composite document rule,” allowing a creditor to prove that multiple documents collectively evidence the security agreement. This is a factual inquiry that looks to whether there are documents containing granting language creating a security interest and that the parties intended the documents to create the security interest. The composite document rule normally turns on whether contemporaneous documents that are signed reflect a grant of a security interest in specific collateral. A financing statement does not ordinarily satisfy the requirement, as it does not contain the granting language and is not usually signed by the debtor. Similarly, a promissory note often references a security interest but is not a security agreement itself. While many courts recognize the composite document rule, it is used sparingly, as parties can easily comply with the minimum requirements of § 9-203(b)(3).

Example 2. Borrower applies for a loan of $10,000, with the application authorizing Bank to file a financing statement as to any security interest in the loan sought. Bank disburses the $10,000, and Borrower signs a promissory note that provides that the Bank may take possession of any collateral upon default. Bank files a financing statement that reflects the collateral as the equipment of Borrower. The parties do not execute a document titled “security agreement.” While Bank may have intended a security interest here, the composite document rule is not satisfied. While it might be argued that the promissory note contains granting language (“Bank may take possession of any collateral upon default”), but even if that were true, the note does not indicate the particular collateral in which the security interest is granted. However, if there was also an email exchange in which Borrower made clear that it was putting up its supercomputer as collateral, then the composite document rule might be satisfied.

Importantly, § 9-203(b)(3) provides other alternatives to satisfy the security agreement 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 additional situations: (i) if the collateral is not a certificated security and is in the *possession* of the secured party; (ii) the collateral is a certificated security 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 letter of credit rights and the secured party has *control* pursuant to the debtor’s security agreement.

Let’s look at examples of each of the three instances where an oral security agreement is sufficient.

Example 3. Niece borrowed $10,000 from Aunt and promised to repay the loan within six months. Niece gave Aunt her valuable Rolex watch to hold until the loan was repaid, but the parties did not sign a written security agreement. Under the rule of § 9-203, Aunt has a security interest in the watch because: (i) Aunt gave value by extending the $10,000 loan; (ii) Niece had rights in the collateral as she owned the watch; and (iii) Aunt took possession of the watch subject to an oral security agreement when the parties agreed Aunt could hold the watch until the loan was repaid. Notice that the security interest attached here pursuant to the oral agreement because Aunt took possession of the watch.

Example 4. Sam borrowed $2,000 from Friend, agreeing that Friend could hold, until the loan was repaid, a stock certificate representing his stock in Willamette Valley Vineyards. Sam delivered the stock certificate to Friend. Under the rule of § 9-203, Friend has a security interest in the stock because: (i) Friend gave value by extending the $2,000 loan; (ii) Sam had rights in the collateral as he owned the stock; and (iii) Friend took delivery of the stock certificate subject to an oral security agreement when the parties agreed that Friend could hold the stock until the loan was repaid and Friend took possession of the certificate. Notice that the security interest attached here pursuant to the oral security agreement because Friend took delivery of the stock certificate by taking possession of it.

Example 5. Music City needed a loan of $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, a security interest attached to the deposit accounts here because: (i) First Bank 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 is the 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 account because the secured party, First Bank, is the bank where the deposit accounts are maintained.

Note that 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 typically is 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). In Example 3, Niece is the debtor because she owns the Rolex watch. Article 9 uses this more limited definition of debtor because it is concerned only with the security interest and not with the financial obligation itself.

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 or the Willamette Valley stock, generally like musical instruments, or even more generally using categories set forth in Article 9, such as equipment, inventory, investment property, or accounts. An important limitation, 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 a security interest attaches to.

At this point, you should be able to describe the process by which a secured creditor can attach its security interest to collateral, thus making it enforceable against the debtor, and to identify the key elements of attachment: (i) value given; (ii) debtor having rights to the collateral; and (iii) proof of a security agreement by 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 Security Agreements.

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