**Value and Rights in the Collateral**

Welcome to this podcast on Value and Rights in the Collateral brought to you by CALI. I am Professor Jennifer S. Martin. This podcast focuses on two of the elements needed to attach a security interest to collateral under Article 9 of the Uniform Commercial Code: value given and a debtor’s rights in the collateral.

Let’s begin with the nature of 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.” 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 right 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—the creditor can foreclose on the collateral if there is a default. In this podcast we will focus on the first two of these requirements (*value given and rights in the collateral*). The security agreement requirement is the subject of a separate podcast.

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 Martin with the clarinet; (ii) the debtor (Martin) had *rights to the collateral* after Music City sold her the clarinet (she now owns it); and (iii) Martin *signed a written security agreement* that granted Music City a security interest and that identified the collateral as the clarinet.

Let’s focus first on the value requirement. Value is defined in U.C.C. § 1-204 and can be satisfied in four different ways. First, value is present when a creditor makes a *binding* commitment to extend credit or for the extension of immediately available credit, whether or not drawn upon and whether or not a charge-back is provided in the event of difficulties in collection. Second, value is given where a party gives security for, or in total or partial satisfaction of, a preexisting claim. Third, value is given when a party accepts delivery under a preexisting contract for purchase. Finally, there is value given where a party provides consideration sufficient to support a simple contract. Notice that § 9-203 requires only that value be given, it does not specify the particulars as to who gives and who gets the value.

Ordinarily, but not always, value is given by the secured party and is given to the debtor. That’s because for purposes of Article 9, the debtor is the person who has rights to the collateral and the obligor is the person who owes the money, but they are often the same person. In Example 1 with Music City, Music City gave value to Martin when Martin accepted delivery of the clarinet under the contract to purchase.

Let’s look at a slightly different extension of credit for the clarinet purchase.

Example 2. Martin wanted to buy a clarinet for her son Marshall, but Music City did not sell instruments on credit. In order to purchase the clarinet, Martin borrowed $1000 from First Bank and Martin granted First Bank a security interest in the clarinet to secure payment of the loan over three years. First Bank gave value to Martin by extending credit (the $1000).

You may recall from your study of contract law that past consideration is generally not sufficient to support a contract. However, under the UCC, value for attaching a security interest can be based on a preexisting obligation. Let’s look at an example.

Example 3. Music City purchased $10,000 worth of instruments for resale from Supplier with an expectation of payment to Supplier in 30 days. Music City was unable to pay Supplier for the instruments as promised, so Supplier had a claim against Music City for the $10,000. Music City granted a security interest to Supplier in its inventory. Here, value was given by Supplier where there is a security interest given in the inventory of Music City on account of the preexisting claim of $10,000. It does not matter that Supplier originally sold the instruments to Music City on an unsecured basis. As there is still a claim against Music City for the unpaid balance, there is value for the later created security interest in the inventory and the security interest can attach.

Moreover, simple consideration is enough to satisfy the value requirement. It does not matter whether the debtor (the person with rights to the collateral) gets the value or someone else does. Let’s look at two examples of this.

Example 4. Music City borrowed $25,000 from Second Bank in order to pay operating expenses. Mary, the owner of Music City, granted Second Bank a security interest in her rare violin as collateral for the loan to Music City. In this case, Mary would be the Article 9 debtor because it is her violin even though Music City is the obligor who will owe payment on the loan. The exchange is that Second Bank is loaning money to Music City in return for (i) Music City’s promise to repay the $25,000 and (ii) Mary’s grant of a security interest in her violin. Recall from Contracts that the promisor does not need to receive the consideration. There is value given by Second Bank even though the security interest is in Mary’s violin and Mary did not receive the value (Music City received it).

Example 5. Daryl borrowed $10,000 from Third Bank to pay for music lessons at Music City. Aunt granted Third Bank a security interest in a diamond tennis bracelet as collateral for Daryl’s loan. The exchange here was the Third Bank loan to Daryl in return for (i) Daryl’s promise of repayment of the $10,000 and (ii) Aunt’s grant of a security interest in her bracelet. Similar to Example 4, Third Bank gave value even though the security interest is in Aunt’s bracelet and Daryl received the value (not Aunt).

Finally, it is worth mentioning that oftentimes the value is easy to spot when loan funds are disbursed to the borrower. However, it does not matter if the loan proceeds are disbursed to the borrower, so long as a binding commitment is made.

Example 6. Music City opened a $100,000 line of credit with Fourth Bank to cover operating expenses as needed. Music City granted a security interest in its equipment and accounts to Fourth Bank as collateral for the loan. Fourth Bank gave value by making a binding loan commitment to Music City, even if Music City has not drawn upon the line of credit.

Let’s move on now. Recall that § 9-203 also requires that 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). The debtor can only transfer an interest in whatever rights they have in the collateral and one who does not have any rights cannot grant a security interest in the collateral. It is obvious that a borrower cannot grant a security interest in an unrelated party’s property because the borrower does not have any rights to that property. However, sometimes an effective security agreement is created where the party with rights to the collateral becomes the debtor by agreeing to the security interest.

Let’s look at two examples.

Example 7. Music City borrowed $25,000 from Second Bank in order to pay operating expenses. Music City would not be able to grant a security interest to Second Bank in Mary’s violin without her permission as Music City does not have rights to the violin (it belongs to Mary). It’s obvious that Music City cannot grant a security interest in an unrelated party’s property, but Mary, as the owner of the business, could do so. It’s important to remember that if Mary, as owner of the violin, agreed to grant a security interest as collateral for Music City’s loan, then Mary would then be the debtor and Music City the obligor on the loan.

Example 8. Music City borrowed $50,000 from Second Bank in order to pay operating expenses, granting Second Bank a security interest in its existing and after acquired inventory. At the time of the loan, Music City had 10 flutes, 5 clarinets and 20 violins in stock. Second Bank’s security interest would attach to those instruments at the time of the loan. Music City then ordered 20 new instruments on the 1st day of each month to add to inventory. As to the new inventory, the security interest of Second Bank would only attach when Music City has rights to the new inventory (upon tender of delivery each month in most cases). Notice that the collateral may change over time as the debtor acquires rights to the collateral covered by the security agreement.

At this point, you should be able to describe and identify two of the key elements of attachment of a security interest: (i) value given; and (ii) the debtor having rights to the collateral. Value is most often given by the creditor to the debtor in the form of a cash loan or goods sold, but there are other ways to establish value. The debtor most often has rights to the collateral due to having title to the collateral or permission of the owner to use the collateral for the loan.

I hope you’ve enjoyed this podcast on Value and Rights in the Collateral.

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