Welcome to this podcast on Priority Between Secured Parties brought to you by CALI. I am Professor Scott J. Burnham.

The topic of this podcast is how to apply the rules found in § 9-322 for determining priority between one secured party and another secured party with an interest in the same collateral. A priority contest requires you to characterize the collateral and characterize each party’s interest in the collateral, and then you have to apply the rule that determines who has priority between those particular parties. For purposes of this podcast, we will limit our discussion to situations where we have characterized the collateral as goods, since other collateral may be perfected by some method other than filing a financing statement.

We start with the basic rule that a secured creditor has priority over an unsecured creditor. This seems obvious, but takes a moment to sink in. For example, many sellers deliver goods to the buyer, provide an invoice for the goods, and expect to be paid within, say, 30 days. This seller in this case is an unsecured creditor, often called a trade creditor. Let’s say the seller sells the goods to a store and the goods become inventory. Presume a bank has loaned money to the store and taken a security interest in the inventory of the store. When the store defaults in its payments to the bank, the bank can foreclose on the inventory and sell it to pay off the debt. It can foreclose on *all* the inventory, including that provided by the trade creditor, who has essentially made a gift of the goods to the bank. Note that in this case it doesn’t matter whether the bank perfected its security interest or not. That makes no difference when a secured party asserts its rights against the debtor. Unless there is an exception, § 9-201 states that “a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.”

Let’s now assume that each party is a secured party. With two secured parties, you need to further characterize the creditors as perfected or unperfected, and whether they have a regular security interest or a PMSI.

Let’s look at priority between an unperfected secured creditor and another unperfected secured creditor. Assume that on August 1, First Bank loaned money to a store and took a security interest in the store’s inventory. On September 1, Second Bank loaned money to the store and took a security interest in the store’s inventory. On October 1, the store defaulted as to both creditors. Which one has priority? The rule of § 9-322(a)(3) is that, as between two unperfected security interests, the first to attach has priority. Therefore, in our hypothetical, First Bank would have priority. Wait a minute, you are saying. This hypothetical doesn’t make sense. Suppose you ran into me one morning and asked me what I was doing. I said, “I am on my way to court to litigate which of two unperfected security interests has priority.” You would say, “Why don’t you stop at the filing office on the way to court so your client isn’t unperfected anymore?” I wondered about that and looked at the cases where this situation has arisen. What I found was that when they went to court, the parties thought they were perfected because they had filed. However, the court determined that they had filed in the wrong place, or used the wrong name, or did one of the other things that make a filing ineffective that you would never do because you pay attention to these CALI lessons and podcasts. Having determined each party had an unperfected security interest, the court then applied the rule for that situation – first to attach.

It probably goes without saying that as between a perfected secured creditor and an unperfected secured creditor, the perfected secured creditor has priority. Since that is obvious, I won’t say it.

The most important rule resolves priority between two perfected secured creditors. The rule of
§ 9-322(a)(1) is simple to state but causes a lot of confusion in its application: first to file or perfect has priority. This rule is simple to apply when one secured creditor files before the other one files, so let’s look at some more complicated examples.

Store asks First Bank to loan it money secured by inventory. With the store’s consent, First Bank files a financing statement on August 1 while the parties are negotiating. Store then goes to Second Bank, which agrees to loan Store money, takes a security interest in inventory, and files on August 15. On September 1, First Bank and Store finish negotiating the terms of their deal and Store signs a security agreement. On October 1, Store defaults as to both banks. Which one has priority? First Bank, of course. It filed on August 1, even though it did not perfect until September 1, since perfection requires attachment. Second Bank perfected and filed on August 15, so First Bank was first to file or perfect. This may seem unfair to Second Bank, but a prudent lender would have checked the filings before extending credit; had Second Bank done so, it would have found the filing of First Bank.

Here’s a tricky one. On August 1, a store sells an antique table to a homeowner on credit and takes a security interest in the table. The store does not file. On September 1, a bank loans money to the homeowner and takes a security interest in the table. The bank immediately files. On October 1, the debtor defaults as to both creditors. Which one has priority? The store, of course. It is a secured creditor with a security interest in the goods that it sold to the debtor, so it had a PMSI. Since the goods were consumer goods, the security interest was automatically perfected when it attached on August 1 as you know from the CALI podcast on Purchase Money Security Interests II. The bank filed on September 1. Therefore, the store was the first to file or perfect.

Here's another tricky one. First Bank loans money to Store secured by inventory. First Bank properly files a financing statement. Within six months, Store pays back the loan. Three years later, Second Bank loans money to Store secured by inventory. Shortly after that, First Bank loans money to Store secured by inventory. Almost immediately, Store defaults. Who has priority in the inventory? First Bank, of course, because it was first to file or perfect. First Bank’s filed financing statement is effective for four years and it doesn’t matter that the first loan was paid back. Second Bank should have searched and after it found the filed financing statement, should have had Store demand that First Bank terminate its financing statement before it made its loan.

One final example. John applies for a loan with Friendly Finance. Friendly tells him that it will loan him the money only if Friendly can take possession of his Babe Ruth autographed baseball until the loan is paid off. John agrees, and Friendly takes the baseball and gives John the money. John then applies to a bank for a loan. The bank asks John to sign a security agreement granting the bank a security interest in his autographed baseball collection. John agrees and after the agreement is signed and the money is transferred, the bank files a financing statement listing “autographed baseball collection” as collateral. John defaults in his payments to the bank. Does the bank have priority in the Babe Ruth autographed baseball? The answer is no. The bank has an effective security interest in that baseball, but it loses priority to Friendly. Recall that according to § 9-203 a security interest created by an oral security agreement attaches to the collateral if the creditor has possession of it. Possession is also perfection according to
§ 9-313. Therefore, Friendly was the first to file or perfect when it took possession of the baseball.

Don’t make the mistake of thinking that when a creditor loses priority, it also loses its security interest. It does not. For example, assume in our example that Friendly had loaned John $1,000 and the baseball was worth $10,000. If the baseball was sold to satisfy the debts, Friendly would first get $1,000 because it has priority, but the bank would still be entitled to apply the remaining $9,000 to the obligation owed.

Are there exceptions to the rule of first to file or perfect? Of course. One exception is the superpriority rules. Bank loans Business money, takes a security interest in the equipment and after-acquired equipment of Business, and properly files. Store sells Business a piece of equipment on credit and properly files. Which one has priority? Bank was first to file or perfect, but under the superpriority rule of
§ 9-324(a), Store has a PMSI which gives it priority in the equipment it sold to Business as long as it filed within 20 days of delivery. For the more complicated rules on the superpriority in inventory, see the CALI podcast Purchase Money Security Interests I.

There are more complicated rules when a secured party can perfect by control. These rules are beyond the scope of this podcast, but kick in when the collateral is deposit accounts, investment property, letter of credit rights, chattel paper, and documents.

I hope you’ve enjoyed this podcast on Priority Between Secured Parties. We have seen that when there is a priority contest, it is necessary to characterize the collateral and the interest of the creditor, and then apply the applicable rule to determine the priority.

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