1.1 Secured Transactions

1.1.1 What is a Secured Transaction?

A secured transaction is a contract between a debtor and a creditor where a security interest exists. You might have heard common phrases like “collateral” or a “lien” which allows creditors to repossess personal property or foreclose upon real estate when the debtor is unable to pay their debts.

Security interest gives creditors an added layer of protection especially in regard to bankruptcy. For example, creditors with a secured interest are more likely than unsecured creditors to recoup all or most of their money upon bankruptcy of the debtor.

1.1.2 Uniformed Commercial Code Article 9

Secured transactions are typically governed by Article 9 of the Uniformed Commercial Code (UCC). However, the UCC covers secured transactions involving personal property only – secured transactions involving real property (houses, commercial real estate, land, etc.) are governed by state law.

What does that mean? Well for the most part, secured transactions involving personal property will default to the rules as prescribed under Article 9 of the UCC. Rules governing security interest of real property will vary from state to state.

1.1.3 Perfection of Security Interest

Perfection of security interest basically means the creditor has taken the legal steps to actually secure their interest in the collateral. The easiest way to secure the interest is by filing the appropriate documentation. The contract itself is not enough to create a secured transaction. The term “perfection” means the creditor files timely and accurate documentation to put a lien on the specified collateral in the contract.

However, there are some exceptions to this general rule. If the collateral is being held by the creditor, then it has been “perfected”. Some examples are security deposits and letters of credit. Another exception is secured interest in household goods and consumer products. For example, if you bought your finance an engagement ring through a collateralized loan then the creditor will generally be able to perfect the security interest automatically.

Some examples:

- John takes out an auto loan that is secured by the car that John wishes to purchase. After John purchases the vehicle, the bank files the appropriate documentation and puts a lien on John’s car. The bank has perfected its interest.

- John borrows $10,000 from a friend to buy a car. The friend agrees to lend him the $10,000 but makes John agree in writing that the car will be returned to him if John defaults. The friend (Rick) never files the appropriate documentation to "perfect" his interest and therefore hasn't secured his interest in the car.
- John borrows $10,00 from his friend Rick to purchase a car. Rick agrees to lend John the money only if John agrees to send him a Bitcoin to secure his interest. Rick will hold the bitcoin until John pays off the balance of the loan and then Rick will return the Bitcoin to John. Since Rick has the Bitcoin in his possession he has "perfected" his interest.

1.1.4 Priority Rules of Secured Transactions

The priority of secured transactions usually follows the first come first served principal. This means that the first debtor to "perfect" their secured interest (usually by filing in the appropriate locality or jurisdiction) will have priority over all other debtors. Essentially, the first debtor to file the appropriate paperwork to secure their interest will win. For example:

- John buys a car using a collateralized loan from his local bank. The bank files the appropriate paperwork and "perfects" the lien against the car. A year later John wants to take out a personal loan and agrees to use his car as collateral. The second debtor files the appropriate paperwork as well. 3 years later John stops paying both the car loan and the personal loan. The car loan will have priority over the personal loan because the first bank filed the appropriate paperwork first.
- John has a boat that is worth $15,000. On January 2nd John takes out a collateralized loan out for $20,0000 secured by his boat. On January 5th John takes another loan out for $5,000 secured by his $15,000 boat. Bank #2 filed the paperwork first to secure the interest in the boat and will take priority over bank #1. Even though the bank #1 entered into the agreement before bank #2 they will not have priority interest because bank #2 filed first.

1.1.5 Key Takeaways

- Understand why a creditor prefers to have a secured interest.
- Understand what falls under the rules of UCC 9 (personal property not real estate).
- Know the ways to perfect interest in a secured transaction (file the proper documentation or possess the collateral).
- Know who has priority in secured interest if default were to occur (First to "perfect" interest has priority).