

SECURED TRANSACTIONS QUESTION

Decorator operates a business that sells decorative items for the office. Eight months ago, Decorator borrowed \$10,000 from Lender and, pursuant to a properly completed and signed security agreement, granted Lender a security interest in all of Decorator's present and future inventory and equipment to secure that indebtedness. Lender filed a properly completed financing statement on the same day that the loan was made and the security agreement was signed.

Seven months ago, Clockwork and Decorator entered into a signed agreement pursuant to which Decorator bought and received delivery of 25 decorative clocks from Clockwork for resale to Decorator's customers. Under the terms of the agreement, Decorator agreed to pay the \$2,500 purchase price in six months. The agreement also provides that, until the payment of the purchase price to Clockwork by Decorator, title to the clocks will be retained by Clockwork. No financing statement was filed in conjunction with this transaction.

Three months ago, Decorator leased an industrial vacuum cleaner from Vac for use in Decorator's business. The lease, which was signed by both parties, provides that, at the end of the four-year lease term (which cannot be terminated early), Decorator will automatically become the owner of the vacuum cleaner so long as all monthly payments have been made. No financing statement was filed in conjunction with this transaction.

Decorator has defaulted on all obligations to Lender, Clockwork, and Vac. Your law firm represents Lender, who has asked the following questions:

1. Who has a superior interest in the clocks? Explain.
2. Who has a superior interest in the vacuum cleaner? Explain.

SECURED TRANSACTIONS ANALYSIS

(Secured Transactions I.B.; II.C.; III.B. & C.; IV.A. & B.)

ANALYSIS

Legal Problems

- (1) What interest does Clockwork have in the clocks?
- (2) Does Lender have an interest in the clocks?
- (3) Whose interest in the clocks—Clockwork's or Lender's—has priority?
- (4) What interest does Vac have in the vacuum cleaner?
- (5) Does Lender have an interest in the vacuum cleaner?
- (6) Whose interest in the vacuum cleaner—Vac's or Lender's—has priority?

DISCUSSION

Summary

Clockwork's interest in the clocks is a security interest governed by Article 9 of the UCC. Because Clockwork did not file a financing statement with respect to its security interest in the clocks, its security interest is unperfected. The clocks are inventory of Decorator, so Lender also has a security interest in them. That interest was perfected when Lender filed a financing statement covering it. Lender's perfected security interest has priority over Clockwork's unperfected interest.

Vac's interest in the vacuum cleaner, although presented as a lease, is a security interest governed by Article 9 of the UCC. Because Vac did not file a financing statement with respect to its interest in the vacuum cleaner, its security interest is unperfected. The vacuum cleaner is equipment of Decorator, so Lender has a security interest in it. Because Lender filed a financing statement, Lender's security interest in the vacuum cleaner is perfected. Unperfected security interests are subordinate to perfected security interests, so Lender's security interest has priority over Vac's.

Point One (25%)

Clockwork has an unperfected security interest in the clocks.

The agreement between Clockwork and Decorator provides that Clockwork retains title to the clocks until their purchase price is paid. Under the Uniform Commercial Code, the substance of a transaction controls, rather than its form or the label given to it by the parties. Because Clockwork's interest exists to secure performance of Decorator's payment obligation, it is a security interest even though the parties did not label it as such. *See* UCC § 1-201(b)(35) [§ 1-201(37) in states that have not enacted revised Article 1 of the UCC].

Secured Transactions Analysis

Because the Clockwork-Decorator transaction created a security interest by contract, it is governed by Article 9 of the Uniform Commercial Code. UCC § 9-109(a)(1). The signed agreement between Clockwork and Decorator is sufficient to create an enforceable and attached security interest because value has been given to Decorator (the extension of credit), Decorator has rights in the clocks, and the agreement between them, providing for Clockwork's retained interest in the clocks, was signed by Decorator. *See* UCC § 9-203. However, in order for Clockwork's security interest to be perfected, Clockwork would need to either have possession of the clocks or file a financing statement with respect to the security interest. *See* UCC § 9-308 *et seq.* Clockwork's security interest in the clocks is not perfected because Clockwork neither filed a financing statement with respect to its security interest nor retained or took possession of the clocks.

[NOTE: An examinee might state that Clockwork's security interest is a purchase-money security interest and, therefore, perfected upon attachment without the necessity of filing a financing statement. This is incorrect. Only purchase-money security interests in *consumer goods* are perfected upon attachment without the filing of a financing statement. *See* UCC § 9-309(1). While Clockwork's security interest is a purchase-money security interest (*see* UCC § 9-103), the clocks do not constitute "consumer goods" in the hands of Decorator because the clocks are being held for sale to Decorator's customers and were not used or bought for Decorator's personal, family, or household purposes. *See* UCC § 9-102(a)(23).]

Point Two (10%)

Lender has a perfected security interest in the clocks.

Pursuant to its agreement with Decorator, Lender was granted a security interest in all Decorator's present and future inventory. Because the clocks are being held by Decorator for resale to its customers, they are inventory. *See* UCC § 9-102(a)(48). The security interest with respect to each clock that Decorator has or subsequently acquires is enforceable and attached because value has been given, Decorator has rights in the clocks, and Decorator has signed the security agreement. *See* UCC § 9-203. The after-acquired property clause is made enforceable by UCC § 9-204. The security interest is perfected because Lender filed a properly completed financing statement with respect to the security interest. *See* UCC §§ 9-308, 9-310.

Point Three (15%)

Lender's security interest in the clocks is superior to that of Clockwork.

While both Clockwork and Lender have security interests in the clocks, only Lender's security interest is perfected. (*See* Points One and Two.) Lender's security interest has priority over that of Clockwork because a perfected security interest is superior to an unperfected security interest in the same property. *See* UCC §§ 9-317(a)(1) and 9-322(a)(2).

[NOTE: An examinee might state that Clockwork's security interest has priority under UCC § 9-324 because it is a purchase-money security interest. This is incorrect. While Clockwork's security interest is a purchase-money security interest (*see* UCC § 9-103), § 9-324 gives priority only to certain *perfected* purchase-money security interests and Clockwork's security interest is unperfected.]

Point Four (25%)

Vac has an unperfected security interest in the vacuum cleaner.

The agreement between Vac and Decorator is presented as a lease. However, the UCC recognizes that the transaction is economically equivalent to a secured sale because Decorator will automatically become the owner of the vacuum cleaner after making all of the lease payments. Accordingly, the interest of Vac is a "security interest." *See* UCC § 1-203 [§ 1-201(37) in states that have not enacted revised Article 1 of the UCC]. Thus, the Vac-Decorator transaction is governed by Article 9 of the Uniform Commercial Code. UCC § 9-109(a)(1). The signed agreement between Vac and Decorator is sufficient to create an enforceable and attached security interest because value has been given to Decorator, Decorator has rights in the vacuum cleaner, and the agreement was signed by Decorator. *See* UCC § 9-203. However, in order for Vac's security interest to be perfected, Vac would need to retain or take possession of the vacuum cleaner or file a financing statement with respect to the security interest. *See* UCC §§ 9-308 *et seq.* Because Vac neither filed a financing statement with respect to its security interest nor retained or took possession of the vacuum cleaner, Vac's security interest in the vacuum cleaner is not perfected.

Point Five (10%)

Lender has a perfected security interest in the vacuum cleaner.

Pursuant to its agreement with Decorator, Lender was granted a security interest in all of Decorator's present and future equipment. Because the vacuum cleaner is used by Decorator in its business and is not inventory, farm products, or consumer goods, it constitutes equipment. *See* UCC § 9-102(a)(33). The security interest with respect to the vacuum cleaner is enforceable and attached because value has been given, Decorator has rights in the vacuum cleaner, and Decorator has signed the security agreement. *See* UCC §§ 9-203 & 9-204. Therefore, Lender's security interest attaches to the vacuum cleaner. The security interest is perfected because Lender filed a properly completed financing statement with respect to the security interest in inventory and equipment. *See* UCC §§ 9-308, 9-310.

Point Six (15%)

Lender's security interest in the vacuum cleaner is superior to that of Vac.

While both Vac and Lender have security interests in the vacuum cleaner, only Lender's security interest is perfected. (*See* Points Four and Five.) Lender's security interest has priority over that of Vac because a perfected security interest is superior to an unperfected security interest in the same property. *See* UCC §§ 9-317(a)(1) & 9-322(a)(2).