Assignment 7:
Perfection by Possession and Control
Reference: Understanding Secured Transactions Ch. 6

Perfection by Possession

• § 9-313(a): Secured party can perfect a SI in the following types of collateral by taking possession of the collateral:
  – Tangible negotiable documents
  – Goods
  – Instruments
  – Money
  – Tangible chattel paper

• Secured party can take possession of the collateral directly, or through an agent or third party [§§ 9-313(a), (c)]
• If SI has already attached, SI is perfected at moment secured party establishes possession [§ 9-308(a)]
• If secured party already has possession before SI attaches, SI is perfected when SI attaches [§ 9-308(a)]
• If SI is perfected only because it has possession of the collateral, secured party’s perfected status lapses (secured party becomes unperfected) if secured party gives up possession of the collateral [§ 9-313(d)]
• Advantages: Debtor can’t damage the collateral or take steps that might violate or threaten the secured party’s rights or the value of the collateral
• Disadvantages:
  – Often not practical (Debtor needs possession/use of collateral, esp. business collateral)
  – Secured party has a duty of reasonable care for collateral in its possession [§ 9-207(a)]
Problem 1

• Neighborly Finance (NF) loans $150K to Abrams to consolidate his credit card debt
• Abrams grants a SI in his comic book collection (which is located in his Regions Bank safe deposit box)
  – Abrams gives NF key to the box to hold until he makes repayment
• Is NF’s SI in the comic book collection perfected by possession? Why or why not?

• NF is probably not perfected by possession as to the comic book collection
  – Abrams still has “possession” of comic book collection b/c he has the legal right to possession/control of the box and its contents
  – Possession of key ≠ possession/control over contents of the box
  – Debtor can’t act as secured party’s agent for purposes of possession [§ 9-313 cmt. 3]
    (ostensible ownership problem not really cured)

• What should Neighborly Finance have done differently?
  – If the parties wanted the comic book collection to remain in a safe deposit box at Regions Bank, that box needs to be SOLELY in the name of Neighborly Finance
  – Neighborly Finance could require Abrams to pay for the cost of the safe deposit box, but Abrams cannot have any legal means for access to the box
• If Abrams proposes to have his lawyer hold possession of the comic collection, would that be sufficient “possession” through an agent?

Problem 1

• Abrams also granted NF a SI in six Leroy Neiman paintings that he owns (on exhibit at Sports Museum)
• NF sends letter to Sports Museum, as follows:
  – “We have a SI in Abrams’s paintings, which are on loan to your collection. Do not release the paintings to Abrams w/out our approval.”
• Has NF perfected its SI in the paintings?
§ 9-313(c). [Collateral in possession of persons other than debtor.] With respect to collateral other than certificated securities and goods covered by a document, a secured party takes possession of collateral in the possession of a person other than the debtor, the secured party, or a lessee of the collateral from the debtor in the ordinary course of the debtor’s business, when:

1. The person in possession authenticates a record acknowledging that it holds possession of the collateral for the secured party’s benefit; or
2. The person takes possession of the collateral after having authenticated a record acknowledging that it will hold possession of collateral for the secured party’s benefit.

- Secured party can establish possession either
  - Directly (secured party has physical possession of collateral) [§ 9-313(a)], or
  - Through a third party agent (who must acknowledge it holds the collateral for the secured party’s benefit, in an authenticated record) [§ 9-313(c)]

- In Problem 1, NF cannot “unilaterally” designate Sports Museum as its agent in possession
  - Note: this is a change from the pre-2000 rule, under which the secured party was deemed perfected “from the time the bailee receives notification of the secured party’s interest” [§ 9-305 (1962 text)]

Problem 2

- Stan’s Bike Shop is in default to Bank, which has SI in “all of Debtor’s equipment and inventory, incl. after-acquired”
  - But, Bank neglected to file its UCC-1, or to have its lien noted on titles for Stan’s vans
- Bank reposs Stan’s bike inventory, two delivery vans
- Sheriff (levying in favor of another creditor) demands that Bank release the bikes and the two delivery vans
- Bank must surrender:
  A. Both the bikes and the vans
  B. The bikes, but not the vans
  C. The vans, but not the bikes
  D. Neither the bikes nor the vans

The Bikes (Ordinary Goods)

- Even though Bank didn’t file a UCC-1, Bank perfected its SI in the bikes at the moment it repossessed them! [§ 9-313(a)]
  - When Sheriff levied, Bank’s SI in bikes was perfected by possession
  - Bank thus has priority over lien creditor [§ 9-317(a)(2)]
The Vans (Titled, Not Inventory)

- Bank’s SI in the vans (covered by the certificate of title statute) was not perfected by Bank’s repossess of the vans [§ 9-313(b)]
- For such vans, notation of lien on title certificate is required to perfect SI [§ 9-311(b)]
- Bank’s SI was unperfected; lien creditor thus has priority over Bank’s unperfected SI in vans [§ 9-317(a)(2)]

Problem 3

- Neighborly Finance is extending a $250,000 line of credit to Sterling Silver. Collateral:
  - Right to monthly installments due Silver from Bowman on a promissory note (36 installments payments remaining)
  - 5,000 shares of Coke stock (certificated)
  - 5,000 shares of Microsoft stock (uncertificated)
  - Silver’s business and personal bank accounts
- If NF files a UCC-1 covering these items, will that be sufficient to perfect NF’s SI?

Problem 3: Bank Accounts

- SI in a “deposit account” [§ 9-102(a)(29)] can be perfected only by “control,” not by filing a financing statement [§ 9-314(a), (b)]
- Rationale: persons taking a transfer of funds from a bank account (e.g., the payee of a check) is not expected to check the UCC records first to see if there might be conflicting claims
  - Bank accounts contain money, which is traditionally viewed as “negotiable” property
Control of Deposit Account

- Secured party can establish “control” over deposit account by one of three methods [§ 9-104(a)]:
  - (1) If the secured party is the bank at which deposit account is maintained (bank can “freeze” account), or
  - (2) If debtor, secured party, and depositary bank enter agreement that bank will comply w/secured party’s instructions re: payment of funds from the account, or
  - (3) Secured party is the depositary bank’s “customer” on the deposit account

Note that a secured party can be perfected by control, even if the debtor is still able to withdraw funds from the deposit account [§ 9-104(b)]
- Otherwise, debtor effectively couldn’t use deposit accounts as collateral
- But: if the debtor pays funds from the account to a good faith transferee, that will extinguish the secured party’s SI in the specific dollars spent [§ 9-332(b)]

SI in a Promissory Note

- Note is an “instrument” [§ 9-102(a)(47)] if it:
  - Evidences a right to payment of a monetary obligation,
  - Is not itself a security agreement or a lease, and
  - Is of a type ordinarily “transferred by delivery with any necessary indorsement or assignment” (e.g., a promissory note or a check)
- Promissory notes typically meet this standard (inspection of note would be needed to make sure)

Problem 3

- SI in an instrument CAN be perfected by filing a UCC-1 filing [§ 9-312(a)]
- But here, Neighborly Finance is better off if it takes takes possession of the promissory note. Why?
“Embodiment”

- For some property, the power to transfer ownership is “embodied” in a writing/record
  - Money (e.g., possession of currency = power to transfer good title)
  - Instruments (e.g., promissory notes, checks)
  - Chattel paper (e.g., installment sale contracts)
  - Negotiable documents of title
  - Stock certificates

- An instrument is said to “embody” the right to payment evidenced by the instrument
- This right to payment is transferred by (1) indorsement of the instrument and (2) delivery of possession of the instrument
  - Many instruments were treated by the common law as “negotiable,” i.e., a good faith transferee of a note who took possession of it took it free of conflicting 3d party claims/interests
  - Transferee of a promissory note was not expected to look to the UCC records for information about conflicting interests (possession = power to transfer)

§ 9-330. Priority of Purchaser of Chattel Paper or Instrument....

(d) [Instrument purchaser’s priority.] Except as otherwise provided in Section 9-331(a), a purchaser of an instrument has priority over a security interest in the instrument perfected by a method other than possession if the purchaser gives value and takes possession of the instrument in good faith and without knowledge that the purchase violates the rights of the secured party.

Problem 3

- Neighborly Finance SHOULD perfect its SI in the Bowman note by taking possession of it
  - If NF leaves Silver in possession of the note, Silver may “negotiate” it to a good faith purchaser who would take free of NF’s SI [§ 9-330(d)]
  - By taking possession, NF negates this risk!
“Negotiability” Rules

- Chattel paper [§ 9-330(a), (b)]
- Instruments [§ 9-330(d)]
- Stock (whether certificated or uncertificated) [§ 8-303(a), (b)] (perfection by “delivery” of share certificates or by “control” of uncertificated securities)

Problem 3: Certificated Security

- Neighborly Finance can perfect its SI in the 5,000 shares of Coke stock by:
  - Filing a financing statement [§ 9-312(a)], or
  - Taking delivery of the stock certificate as specified in § 8-301 (by taking possession of the certificate) [§ 9-313(a)], or
  - Taking control of the stock certificate as specified in § 8-106(b) [§§ 9-106(a), 9-314(a)]

Problem 3: Control of Coke Stock

- Stock certificates come in either “bearer” form [§ 8-102(a)(2)] or “registered form” [§ 8-102(a)(13)]
  - If in “bearer form,” control can occur only by delivery of share certificate [§ 8-106(a)]
  - If in “registered form,” control requires delivery of certificate + either (1) indorsement or (2) registration of transfer [§ 8-106(b)]

- Again, NF should perfect by delivery or control, not by filing a UCC-1
- If Silver retains control of the stock certificate, he can effectively transfer good title to the stock to third parties (the certificate is “negotiable”)
  - Good faith purchaser of stock who pays value and takes possession of certificate (indorsed to him by Smith), w/out knowledge of NF’s SI, would take stock free of NF’s SI [§ 8-303(a), (b)]
Uncertificated Securities

• NF can perfect its SI in the 5,000 shares of Microsoft stock by:
  – Filing a UCC-1 covering the stock [§ 9-312(a)], or
  – Taking “control” of the stock under § 8-106(c) [§§ 9-106(a), 9-314(a)]
    • Control would usually require Microsoft to agree to comply with NF’s instructions regarding transfer of the stock [§ 8-106(c)(2)]

Can NF safely rely upon filing a UCC-1 to perfect its SI in the Microsoft stock?
  – No! Even noncertificated securities are treated as “negotiable”
  – Unless NF obtains “control,” Silver could effectively transfer good title to a third party
    • E.g., Silver sells stock to Litton, who pays value, and has transfer reflected on Microsoft books (i.e., Litton now registered as the owner of the shares)
    • If Litton lacked knowledge of NF’s SI, Litton would take the stock free of NF’s SI [§ 8-303(a),(b)]

Problem 4

• Tate wants to borrow $250,000 from Bank
  – Collateral = 100,000 bushels of corn owned by Tate, currently stored at Midwest Grain LLC
• Bank can perfect its SI by filing a UCC-1 describing the corn [§ 9-310(a)]
• Why might Bank not want to rely upon filing to perfect its SI?

Documents of Title (“Document”)

• Manufacturers/producers of goods may “warehouse” them pending sale
• Warehouse issues a document of title [“document,” § 9-102(a)(30)], which is also called a “warehouse receipt” [§ 7-201(a)]
  – These receipts can be in negotiable form [§ 7-501] or nonnegotiable form
Tangible Negotiable Documents

• Problem: Midwest Grain LLC probably issued a negotiable document of title (“document”) that “embodies” ownership of 100,000 bushels of corn
  – This document would allow Tate to transfer title to the corn by negotiation (transfer) of the document
  – Buyer to whom document is negotiated would get title to the document and the corn, and could thereafter present the document to Midwest Grain LLC to get possession of the corn [§ 7-502(a)]

Tangible Negotiable Documents

• If the corn is covered by a negotiable document, Bank needs to get possession of the document itself (to prevent its “negotiation” to a BFP)
  • While the corn is in possession of Midwest Grain LLC and is covered by a negotiable document, Bank can perfect its SI in the corn by taking and perfecting a SI in the document [§ 9-312(c)(1)], which is best done by taking possession of the document [§ 9-313]

• Note: Bank could perfect by filing a UCC-1 covering the corn [§ 9-310(a)] or a UCC-1 covering the document [§ 9-312(a), (c)]
  • But, Bank would be smarter to perfect by taking possession of the document, because:
    – Taking possession of the document prevents its negotiation to a BFP who could take the document (and thus the corn) free of Bank’s SI [§ 9-331(a)]
    – Taking possession of the document would also give Bank priority over a conflicting SI in the corn perfected by any other method [§ 9-312(c)(2)]