

SUBJECT: Substitution of Collateral

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INTRODUCTION

This release applies to all credit unions, state or federal. It recommends procedures to follow when permitting a member to substitute collateral securing a loan.

EXECUTIVE SUMMARY

When a credit union grants a member's request to substitute new collateral for that originally offered, the credit union may do so without rewriting the note. This assumes there is no new money loaned to the member by the credit union and no other change in terms. A security agreement describing the new collateral is signed by the member/debtor. A memorandum of the substitution of collateral, as shown in this release, may be retained in the credit union's file, along with copies of the new and old security agreements. The credit union releases the old lien and perfect the new lien.

REQUEST FOR SUBSTITUTION

Suppose you are asked by a member to release your lien on her car because she wants to trade it in on a newer model. Assume there is no need to borrow additional money and the member is willing to offer the newer model as security for the existing credit union loan. What do you do?

There is an alternative to rewriting the loan, requiring a new payment and due date. The credit union can maintain continuity in loan payments and due dates according to the original contract, essentially by simply rewriting the security agreement.

The credit committee or loan officer first evaluates whether or not the collateral offered for substitution has sufficient value to secure the remaining loan balance.

- If not, the exchange should be denied unless other collateral is offered.
- If so, the loan officer must take steps to release the credit union's lien on the old collateral and file a lien on the substitute collateral as described in this release.

In accepting the substitute collateral, a new security agreement is normally written, taking a lien on that collateral. The credit union then perfects its security interest in the new collateral.

MEMORANDUM

There is an important step the credit union should take to provide an audit trail. A notice, such as the one which follows, is attached to the old security agreement.

See next page for an example.

MEMORANDUM

(DATE)

On behalf of _____ Credit Union, the undersigned loan officer/credit committee hereby releases a secured interest in _____ as security for a note dated _____, 19____.

In exchange, the credit union accepts _____ as collateral as described in a security agreement dated _____, 19____.

By: _____
(Signature)

(Loan Officer/Credit Committee)

This document is approved by the loan officer or credit committee, and dated the same day as the new security agreement.

NOTE AND DISCLOSURE REMAIN AS IS

The credit union need not concern itself with redisclosing the collateral under Truth in Lending, as long as the procedures in this release are followed. Of course, the credit union reminds the member that payments and due dates on the loan remain the same.

In no event should the note or Truth in Lending disclosures be altered by cross-outs or additions. True, they will not make reference to the substituted collateral, but they serve as the record of the original agreement.

RETENTION OF SECURITY AGREEMENTS

The credit union retains its copies of the new and old security agreements, at least until the loan has been paid.

There are two reasons the old security agreement is kept. First, there may be some collateral remaining on the original security agreement which still secures the loan. There is no need to include that collateral on the new security agreement—a note may be secured by several security agreements.

Second, and more importantly, the old or original security agreement helps maintain an audit trail referencing the original items disclosed on the note.

RELEASE OLD / FILE NEW UCC

When a lien is to be released on a titled vehicle, follow the Department of Transportation procedures described in *ii Release No. B044*. For collateral perfected with a UCC-1 form, file form UCC-4 with the Department of Financial Institutions to release the old lien. Perfect the new lien by filing a UCC-1 form. See *ii Release No. B028* for more guidance on UCC filings.

League publications are designed to provide accurate information with regard to the subject matter covered, with the understanding that the League does not render legal services. If you have general questions regarding this release, please call The League at (608) 640-4050 if local; or (800) 242-0833. For specific legal advice, please consult your credit union's attorney.

Legal Affairs Department

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