

# PUBLICATION

---

## It's a Bird...it's a Plane...it's a SUPER-Priority Purchase Money Security Interest!!!

November 01, 2011

The UCC gives special benefits to a "Purchase Money Security Interest" which, generally speaking, is a security interest in Goods or certain software (called "**purchase money collateral**") that secures an obligation of an obligor (1) incurred as all or part of the price of the collateral or (2) for value given to enable the Debtor to acquire rights in or the use of the collateral if the value is in fact so used (called a "**purchase money obligation**").<sup>[1]</sup>

Traditionally, purchase money collateral could only consist of "Goods" but the revised version of Article 9 enacted in 2001 expanded this concept to allow purchase money priority in software which is not embedded in the Goods if (1) the Debtor acquired its interest in the software in an integrated transaction in which it acquired an interest in the Goods; and (2) the Debtor acquired its interest in the software for the principal purpose of using the software in the Goods.<sup>[2]</sup> To this limited extent, a purchase money security interest (sometimes called a "**PMSI**") can exist in a General Intangible (which is the proper classification of software not embedded in Goods).

When perfected in accordance with the terms of the purchase money rules, a PMSI takes priority over a competing interest in the purchase money collateral even if another Secured Party has a security interest covering that same collateral that was perfected under a previously-filed financing statement (such as a senior secured lender with an all asset filing).<sup>[3]</sup> A PMSI also will have priority over a lien creditor whose interest arises prior to the date of the PMSI.<sup>[4]</sup> For purposes of simplicity, this issue of Dispatches from the Trenches refers to the conflicting Secured Party who is primed by the PMSI as the "Existing Lender" and the Secured Party providing the purchase money financing as the "PMSI Lender."

The concept of a PMSI arose to encourage borrowers to acquire new items financed by the vendor or a third-party lender who makes the acquisition possible. The theory is that the Existing Lender is not "hurt" in any way by granting priority to the PMSI Lender because, if it weren't for the loan made by the PMSI Lender, the purchase money collateral wouldn't be owned by the Debtor in the first place. However, an Existing Lender may receive some comfort from property which it mistakenly believes the Debtor owns free and clear of liens and, as such, Article 9 places certain burdens on the PMSI Lender to evidence its lien in a timely fashion.

In order to qualify for purchase money priority, the PMSI Lender must follow certain rules. Those rules vary depending on whether the underlying collateral constitutes "Equipment" or "Inventory" under Article 9.<sup>[5]</sup> The applicable criteria are more cumbersome with respect to Inventory than in standard financing transactions that involve "Equipment."

### 1. Enable the Debtor to Acquire the Equipment.

For both Equipment and Inventory, a purchase-money security interest, by definition, requires that the loan proceeds "enable the Debtor to acquire rights in or the use of the collateral."<sup>[6]</sup>

This standard is arguably not met by a loan that permits the Debtor to *retain* collateral already in its possession or for which it has already paid. As such, the safest way to assure that this requirement has been satisfied is for the PMSI Lender to pay the vendor directly for the Goods. Reimbursing the Debtor can cause problems

since some courts have held that reimbursing the Debtor directly means it was the Debtor's money (and not the PMSI Lender's loan) that allowed the Debtor to acquire rights in the Equipment and have therefore disallowed PMSI treatment. Other cases have held that as long as the Debtor's payment to the vendor and the Secured Party's reimbursement of the Debtor are closely connected in time and planning, they should be viewed as part of the same transaction-- therefore allowing PMSI treatment.

In the event the Debtor has made a down payment to the vendor, it is best, if possible, to fund the full amount to the vendor and require the vendor to reimburse the Debtor.

## 2. Perfection within 20 Days of Possession for Equipment.

For Equipment, the PMSI Lender must be perfected either before or within 20 days after the date the Debtor receives "possession" of the equipment. Remember that perfection requires both: (a) a grant of a security interest, the giving of value and the Debtor having rights in the collateral; and (b) a filed financing statement perfecting the security interest.

Sometimes it is easy to determine when possession begins because the borrower signs some form of delivery receipt or the vendor has written evidence of the date of delivery. Sometimes the situation is confusing, however, as where the period between the delivery and the date of acceptance is extended due to testing, repair, additional deliveries of necessary pieces, etc. . . .

The UCC offers some guidance where deliveries occur in stages, stating that the 20 day period begins when "it would be apparent to a potential lender to the Debtor that the Debtor has acquired an interest in the goods taken as a whole."<sup>[7]</sup>

There is also some statutory and case law indicating that taking possession as a lessee (such as under a rental agreement), rather than as an owner is not enough to begin the 20 days running. In particular, the UCC provides:

"[One] issue concerning the time when 'the debtor receives possession' arises when a person acquires possession of goods under a transaction that is not governed by this article and then later agrees to buy the goods on secured credit. For example, a person may take possession of goods as lessee under a lease contract and then exercise an option to purchase the goods from the lessor on secured credit. Under section 2A-307(1), creditors of the lessee generally take subject to the lease contract; filing a financing statement against the lessee is unnecessary to protect the Lessor's leasehold or residual interest. Once the lease is converted to a security interest, filing a financing statement is necessary to protect the seller's (former Lessor's) security interest. Accordingly, the 20-day period in [this Section] does not commence until the goods become "collateral" (defined in section 9-102), i.e., until they are subject to a security interest."

This commentary is technically meant to address a situation where the lessor under a true lease finances the purchase option owed by the lessee. It basically says that the 20 day clock starts to tick once the "lease" is converted into a "secured loan."

However, some lenders rely on this logic when financing the purchase option that a lessee has under a lease with a third party (although this situation is slightly different than the example since the lessor is not the party that eventually becomes the secured lender).

## 3. Additional Requirements for PMSI in Inventory.

Since inventory which is held for sale may be converted into accounts or other payment obligations, sometimes fairly quickly, and Existing Lenders that finance such inventory often expect for it to roll-over from time to time, Article 9 places more stringent requirements on PMSI Lenders intending to obtain a PMSI in Inventory. Complying with PMSI rules for Inventory requires the following:

1. The PMSI Lender must conduct a UCC Search against that entity to reveal all Secured Parties of record as of that time.
2. The PMSI Lender must review the search results to see if any existing filings cover either "Inventory" or the type of goods that the PMSI Lender will be financing (e.g. construction equipment). If any of these filings are found, the PMSI Lender needs to send a PMSI Notice to the Secured Party who filed that financing statement. Such mailings should be accomplished in a manner that allows the PMSI Lender to provide such notices were sent. This notice is "good for" 5 years. Some lenders simply send PMSI notices to any secured creditors revealed by the search (rather than spending time or taking the risk of operations personnel making a judgment call as to the scope of the filing).
3. The PMSI Lender must have **perfected** the security interest (meaning there is a grant of a security interest under a signed document **and** a UCC financing statement filing in place) **on or before** the date the Debtor receives possession of the inventory. In other words, the 20 day window available for equipment is not available for inventory.

If future transactions are contemplated, the PMSI Lender may want to word its notices and the collateral description on its financing statements broadly so as to avoid having to repeat the foregoing each time.

One issue meriting additional attention is the requirement that a PMSI Lender have a perfected interest when Goods are first possessed by its Debtor, This requirement is tricky in some industries (especially for some traditional equipment leasing companies). As long as the UCC filing is broad enough to cover future schedules and unlisted goods that are later subject to those schedules, it should be relatively easy to avoid the timing problem with respect to the UCC filing after the first transaction. However, equipment lessors still need to have the grant of a security interest effective **when** the Goods are delivered. Some equipment finance agreements and leases intended as security operate to have the lease commence and the security interest granted **after** delivery and inspection. This technical glitch could theoretically cause problems and the safer approach is to have the grant effective no later than upon delivery.

Another issue is the description on the notices sent to Existing Lenders. Article 9 does not provide much guidance as to what constitutes a sufficient description of collateral in the notice. However, it is important to understand that its purpose is simply to place the other creditors on notice of the PMSI Lender's potential interest, thereby allowing them the opportunity to contact the PMSI Lender for more detail. Arguably, the "reasonably identifies" standard for security agreement descriptions of §9-108(a) should be the benchmark. However, that section expressly provides that a description of the collateral by category—for example, "inventory"—constitutes "reasonable identification." Obviously, a description so vague does not help the existing inventory financier identify the Goods subject to the PMSI.

That being said, given the very general description requirement under revised §9-504 for financing statements, the drafters of Article 9 may have expected a general description to be sufficient because it would put the Existing Lenders on notice that another creditor might have a claim to some of Debtor's inventory. Any reasonable Existing Lender could investigate and could obtain a list from the PMSI Lender of specific Goods in which it has a PMSI.

Further, it seems unreasonable to require a specific description of the inventory in order to get a super-priority--especially given that the statute provides for the notice to be "good" for 5 years.

Many PMSI Lenders provide a very broad description (anything it finances) **and**, if possible, a slightly more narrow one ("including, without limitation, construction equipment or various diggers, cranes, lifts, drills, and other accessions, attachments or additions to vehicles"). For a captive finance company, it is easier to craft a notice which identifies Goods of every kind and description manufactured or sold by its vendor affiliate(s).

#### 4. Conclusions

A PMSI is a useful arrow in the quiver of many equipment finance companies. Of course, no legal weapons or tools are one-hundred percent effective. It is crucial, therefore, for a PMSI Lender to have a good understanding of the requirements of a purchase money security interest and to maintain adequate records evidencing that those requirements have been met. Carefully drafted documents and diligently formulated procedures are a must.

---

[1] U.C.C. §9-103(a).

[2] U.C.C. §9-103(c).

[3] U.C.C. §9-324.

[4] U.C.C. §9-317(e).

[5] See U.C.C. §9-324.

[6] U.C.C. §9-103(a)(2).

[7] U.C.C. § 9-324, Official Comment No. 3.