

LAW101DL, COMMERCIAL LAW, Secured Transactions, Professor Widen [draft: 4/7/2020 3:26 PM]

**LECTURE NOTES: TEXT-CHAPTER 11, p. 715 and ff.**

OUTLINE: PURCHASE MONEY SECURITY INTERESTS

## **I. Background**

A reading of UCC s.9-201, in isolation from other provisions of Article 9, might suggest to some that a security agreement is enforceable by the creditor against its debtor in accordance with its terms AND also is enforceable against third parties, including purchasers and creditors.

[begin statute quote]

s. 9-201. GENERAL EFFECTIVENESS OF SECURITY AGREEMENT.

(a) [General effectiveness.]

Except as otherwise provided in [the Uniform Commercial Code], a security agreement is effective according to its terms between the parties, against purchasers of the collateral, and against creditors.

\* \* \*

[end statute quote]

The key statutory language which overrules the general provision about a security agreement being effective "according to its terms" is "***Except as otherwise provided in [the Uniform Commercial Code],***".

While a creditor may enforce an unperfected security interest against the debtor as a simple matter of contract law, for a security interest to be enforceable against third parties, as a general matter that security interest must be perfected. And, as between two conflicting security interests claimed in the same item of collateral, legal rules must decide which party should prevail. UCC Article 9 contains these rules--giving content to the "except as otherwise provided" proviso in s.9-201.

*Two general rules govern the priority of security interests.*

In outline, these rules state: (1) a perfected security interest has priority over an unperfected security interest; and, (2) as between two perfected security interests, the first secured party to file a financing statement or perfect its security interest has priority over a later filed or perfected security interest.

The second rule is stated in terms of the "first to file or perfect" to address the potential for "ties" in priority when two security interests attach at the same time. For example, the "first to file or perfect" formulation of the rule handles the case in which SP1 and SP2 both have security agreements which cover after-acquired property of the same type. When a debtor acquires the property subject to these two security agreements, the security interests in the after-acquired property attach and are perfected at the same time. However, if SP1 had filed a UCC-1 prior to the time that SP2 filed a UCC-1, the first to file or perfect rule would give SP1's security interest priority over SP2's security interest because SP1 filed its financing statement first.

Giving priority to the "first to file or perfect" is a specific instance of the general maxim that "first in time is first in right."

## **II. Purchase Money Security Interests as an exception to the general priority rules**

A significant exception to the first to file or perfect rule of priority is the exception for "purchase money security interests" or PMSI's. In brief, a PMSI arises when a creditor extends credit to a debtor to enable a debtor to acquire a good and the creditor takes a security interest in the good to secure repayment of the price. As a general matter, a properly perfected PMSI has priority over an earlier filed security interest. There are, however, a number of details relating to PMSI's. Two main questions arise for analysis of a PMSI in a typical business transaction: (1) is the credit extended to enable the purchase of (i) inventory or (ii) equipment; and, (2) is the credit financing provided by (i) the seller of the good or (ii) a third-party lender? There is a special rule for a PMSI in a consumer transaction.

The UCC does not require that either the security agreement or the financing statement used in a PMSI transaction state that the loan secured is secured by a "purchase money security interest" or "PMSI". A creditor may only obtain a PMSI in goods and software. No other asset classes qualify for PMSI status. For example, a secured party may not acquire a PMSI in: accounts, chattel paper, documents, general intangibles or instruments.

The UCC further limits the extent of a PMSI in software: the software must be acquired by the debtor in a transaction in which the creditor obtains a PMSI in goods which use the software. A PMSI transaction may not

exist for a "software only" transaction. Recall that under the UCC the asset class of "goods" includes: consumer goods, crops, fixtures, equipment, inventory, livestock and manufactured homes. Note that if the security agreement is intended to cover software, the description of collateral should include a reference to software—and not simply rely on the reference to “goods” in which the software is used. As a further complication, in a consumer goods transaction, even though the PMSI is automatically perfected upon attachment with respect to the good, the automatic perfection does not extend to the embedded software—a financing statement must be filed to perfect the PMSI in the software (or, in theory, the secured party might retain possession of the goods—an inconvenient possibility).

### **III. A fact pattern showing the importance of PMSI's**

A fact pattern illustrates these details and why the special exceptions to the priority rules for PMSI's are important.

Suppose Job Creator, Inc., a Delaware corporation (JC), has a revolving credit agreement with Big Bank, NA (BB). This credit agreement is secured by a security interest in all personal property assets of JC. JC signed a security agreement stating that it secures all advances and extensions of credit under the revolving credit agreement made from time to time. The granting clause of the security agreement creating the security interest covers, among other assets, "all equipment, inventory, accounts, chattel paper and deposit accounts of JC, whether now owned or hereafter acquired." This kind of security interest is common. In business jargon it is sometimes called a "blanket" security interest (because it covers all the property of the debtor).

Suppose that BB properly filed a financing statement with the Delaware Secretary of State on April 1, 2018, to perfect its security interest. And, suppose that JC's bank account is maintained at BB. Now, on January 15, 2019, JC decides to purchase a GREEN Machine from GREEN Co. to use on its assembly line to help manufacture widgets. On that same date, JC decides to purchase 100 RED widget covers from RED LLC. JC intends to offer these RED widget covers for sale to its customers who purchase widgets from it.

JC has a number of options for the purchase of the GREEN Machine and the RED widget covers. JC might have available cash on hand which it could use to purchase these assets. This presents no particular problems for security interest conflicts--but JC must have sufficient cash to make the purchase. Assume JC has sufficient funds in its deposit account. JC writes checks to GREEN Co. and RED LCC drawn on its bank account with BB. GREEN Co. and RED LLC will acquire the payment free and clear of any security interest in the funds which BB had, and JC will acquire the assets. Upon delivery of these goods, JC will acquire rights in the collateral and BB's security interest will attach. [If JC delivered checks to GREEN Co. and RED LLC which "bounced" for insufficient funds both sellers might attempt to reclaim the goods from JC and a potential conflict is created between the reclamation interests of the sellers and the security interest of BB!]

Alternately, JC might borrow money under its revolving credit agreement with BB to finance the purchase. Such a borrowing might be possible if there were unused availability under the revolving credit agreement and if the use of funds for these purposes was permitted under the terms of the revolving credit agreement. BB's security interest would attach to the Green Machine and the RED widget covers when JC purchases them.

However, JC might not wish either to use available cash to make these purchases or to borrow additional funds from BB. Suppose JC wants to finance these purchases using credit extended by different lenders. Perhaps GREEN Co. is offering very attractive financing terms to its customers in order to boost its sales volume. Suppose further that Local Bank has offered a good deal on inventory financing for its new business customers (together with a free toaster). JC is considering opening a business checking account with Local Bank to qualify for this financing offer.

The problem for GREEN Co. and Local Bank on these facts is the combination of the blanket security interest of BB (including an after-acquired property clause) and the first to file or perfect rule. On these facts, BB filed in 2018 and it clearly is the first to file. IF these rules operate to give BB a priority security interest in the GREEN Machine and the RED widget covers, THEN it is unlikely that either GREEN Co. or Local Bank will decide to finance these purchases. JC would only have two alternatives--a purchase for cash or to obtain financing from BB. Here is where the special rules for PMSI operate. It is possible for GREEN Co. to loan funds to JC to enable the purchase of the Green Machine on a first priority secured basis (i.e. ahead of BB's security interest). Similarly, it is possible for Local Bank to loan funds to JC to enable the purchase of the RED widget covers from RED LCC on a first priority secured basis (also ahead of BB's security interest). However, to obtain the PMSI priority, each must follow the special PMSI rules, one which applies to equipment and one which applies to inventory.

#### **IV. The PMSI in equipment**

The general PMSI priority rule which applies to equipment is stated in UCC s.9-324(a). Note that this rule applies to a perfected purchase-money security interest in any goods OTHER THAN INVENTORY OR LIVESTOCK (and is not limited to equipment).

**[begin statute quote]**

s. 9-324. PRIORITY OF PURCHASE-MONEY SECURITY INTERESTS.

(a) [General rule: purchase-money priority.]

Except as otherwise provided in subsection (g), a perfected purchase-money security interest in goods other than inventory or livestock has priority over a conflicting security interest in the same goods, and, except as otherwise provided in Section 9-327, a perfected security interest in its identifiable proceeds also has priority, if the purchase-money security interest is perfected when the debtor receives possession of the collateral or within 20 days thereafter.

\* \* \*

**[end statute quote]**

To obtain the special PMSI priority in equipment, GREEN Co. simply must perfect its security interest in the GREEN Machine when JC receives possession of the machine or within 20 days thereafter. Thus, GREEN Co. would either pre-file its financing statement, file its financing statement simultaneously with the transfer of possession or within 20 days thereafter. Suppose a "delivery" contract, with the carrier arriving at JC's address to transfer possession on January 21, 2019, a Monday. Using our day counting convention, we exclude the 21st of January from our count. "Within 20 days thereafter" of January 21st extends to February 10, a Sunday. Sunday should not count as the last day, so a UCC-1 filing would be timely if made on or before Monday, February 11, 2019. The result should not change with a "shipment" contract because the 20 day period is not measured from "delivery" of the good but from the time when the debtor "receives possession of the collateral." Significantly, there is a 20 day grace period after transfer of possession within which a secured credit may perfect and still receive PMSI status. A secured creditor may perfect after this time, but such a delayed perfection will not allow the secured creditor to take advantage of the special PMSI priority.



## V. The PMSI in inventory

Contrast this general PMSI rule which applies to equipment with the special rule for inventory. There is no grace period to file with respect to inventory AND the secured creditor must send a notice meeting certain requirements to certain other secured parties holding conflicting security interests.

The general PMSI priority rule which applies to inventory is stated in UCC s.9-324(b).

### [begin statute quote]

s. 9-324. PRIORITY OF PURCHASE-MONEY SECURITY INTERESTS.

\* \* \*

(b) [Inventory purchase-money priority.]

Subject to subsection (c) and except as otherwise provided in subsection (g), a perfected purchase-money security interest in inventory has priority over a conflicting security interest in the same inventory, has priority over a conflicting security interest in chattel paper or an instrument constituting proceeds of the inventory and in proceeds of the chattel paper, if so provided in Section 9-330, and, except as otherwise provided in Section 9-327, also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:

- (1) the purchase-money security interest is perfected when the debtor receives possession of the inventory;
- (2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
- (3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
- (4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

\* \* \*

**[end statute quote]**

To obtain the PMSI priority in inventory, the security interest must be perfected "when the debtor receives possession of the inventory." As a practical matter, this means that the creditor must pre-file its financing statement. In addition, the secured creditor must send an "authenticated notification" to the holders of conflicting security interests (which the holders of conflicting security interests must have received within 5 years prior the date on which the debtor received possession of the inventory) and the notification must state that the secured party "has or expects to acquire a purchase-money security interest in inventory of the debtor" and it must describe the inventory.

Thus, it is a much more complicated procedure to obtain PMSI priority in inventory. The procedure is further complicated because s.9-324(c) describes which holders of conflicting security interests should receive notice. Fortunately, s. 9-324(c) is logical. It requires notice only to holders of conflicting security interests who have filed financing statements prior to the time our PMSI lender perfects by filing, in the usual case (or who have filed prior to the time of temporary perfection, as will be explained below).

**[begin statute quote]**

s. 9-324. PRIORITY OF PURCHASE-MONEY SECURITY INTERESTS.

\* \* \*

(c) [Holders of conflicting inventory security interests to be notified.]

Subsections (b)(2) through (4) apply only if the holder of the conflicting security interest had filed a financing statement covering the same types of inventory:

- (1) if the purchase-money security interest is perfected by filing, before the date of the filing; or
- (2) if the purchase-money security interest is temporarily perfected without filing or possession under Section 9-312(f), before the beginning of the 20-day period thereunder.

\* \* \* **[end statute quote]**

## **VI. Necessary steps for a PMSI in inventory perfected by filing**

Consider the steps that Local Bank needs to take to obtain a PMSI in the inventory which has priority over BB if Local Bank intends to perfect its PMSI by filing a financing statement.

First, Local Bank must perform a search of the applicable UCC filing office--here, the Secretary of State of Delaware. Local Bank will (hopefully) find the prior financing statement filed by Big Bank. [In Delaware, the Division of Corporations within the Secretary of State's office is responsible for UCC filings. This division has published detailed administrative rules which explain how UCC searches work in Delaware. See ADMINISTRATIVE RULES OF THE DELAWARE SECRETARY OF STATE, Division of Corporations, UNIFORM COMMERCIAL CODE REVISED ARTICLE 9, revised 7/11/2017 (available at: <https://corpfiles.delaware.gov/uccadminrules.pdf>).] In actual practice, Local Bank's law firm will probably pay a search firm to conduct this search and deliver the results. One such search firm is CT Corporation System, now owned by Wolters Kluwer (look for "UCC services"). Another is First American Title Company, which not only offers search services but also UCC insurance.

Suppose that BB's financing statement covers the same types of inventory as Local Bank hopes to finance (e.g. widget covers). For a blanket security interest, BB likely used a super-generic indication of collateral which, by default, would cover all types of inventory, as well as other collateral. Local Bank will send an "authenticated" notification to BB. In the usual case, this authenticated notification will be a signed letter or other paper writing. However, an electronic notice may be authenticated per the definition of "authenticate." See s.9-102(7). The notice will be sent to the mailing address of the secured party listed on BB's UCC-1. [The

national form contains a mailing address but not an email address, though in some cases it may be possible to send the notice by email--however consider how you would confirm that you sent the notice to the correct email address within a large organization such as BB--much safer to use the address BB provided on its UCC-1 form.]

Local Bank will send this notification to BB with a return receipt requested (if it is sent by mail) to obtain evidence of the date on which BB received the notification so it can measure the five year period and otherwise prove that BB received the notice. [Note, for periods measured in years, rather than days, the rules about excluding Sundays and holidays typically do not apply.]

Then, Local Bank will pre-file its own financing statement. Because Local Bank is "pre-filing," JC will not yet have authenticated a security agreement. Thus, Local Bank will need to have JC authorize the filing of the financing statement in an authenticated record. See s.9-509(a). Following the pre-filing, Local Bank will perform a second search, both to make sure its financing statement was properly recorded and to make sure no additional financing statement was filed by another secured party which appeared after it performed its initial search and before its pre-filed financing statement was recorded. It will wait to receive the "return receipt" to make sure that BB received its notification. After all of this (and only then) can Local Bank make an enabling loan to JC and be assured the loan qualifies for the PMSI priority.

## **VII. Temporary perfection and the field warehouse**

Prior to enactment of Article 9 it was difficult to perfect a security interest in inventory--in many cases there was no effective filing system in place for recording a security interest. The only way to perfect the interest in goods constituting inventory was for the secured party to take possession of the inventory. This, of course, is not very practical as the debtor needs possession of its inventory in order to make sales. The cumbersome practice developed of using a "field warehousing" arrangement. In a field warehousing lending structure, the creditor fences off a portion of the debtor's warehouse or other storage facility--usually with a chain link fence and a door with a lock and a key. An employee of the creditor stays on the site of the field warehouse and turns over inventory to the debtor, as needed, to enable the debtor to make a sale. In this way, the creditor is deemed to be in possession of the inventory and thus "perfects" its security interest by maintaining sole dominion and control over the inventory.

In such a case, the creditor does not file to perfect its security interest. And, the creditor loses possession of the property when it turns over an item of inventory to the debtor to allow the debtor to make a sale. Ordinarily this loss of possession would result in the loss of perfection. Under Article 9, however, there is a 20-day period following the turnover of the inventory to the debtor in which the creditor's security interest in the inventory is deemed perfected in the absence of either filing or possession. This is the 20 day temporary perfection referred to in s.9-324(c)(2) which states: "(2) if the purchase-money security interest is temporarily perfected without filing or possession under Section 9-312(f), before the beginning of the 20-day period thereunder." All this means is that a creditor using a field warehousing or similar arrangement must give notice to the other

creditors who have filed a financing statement covering inventory who appear on the record before commencement of the 20-day temporary perfection period.

Field warehousing is an expensive and awkward procedure. It is no longer needed for perfection, as filing a UCC-1 is available. However, it does provide an added layer of protection which some creditors might require in special circumstances or for certain types of valuable assets.

### **VIII. Policy rationale for difference in treatment between PMSI's in equipment and inventory**

One reason why the procedures may be more elaborate for inventory than for equipment relates to common commercial practices associated with the provision of revolving credit. Lenders like BB often use a "borrowing base" to determine the amount of credit which they will extend to a borrower like JC. A borrowing base often includes inventory in its calculation (usually allowing borrowings in a principal amount equal to 50% of the value of "eligible inventory" as defined in the credit agreement). In a secured loan, the 50% advance rate set for lending against inventory is set on the assumption that BB has a first priority claim in the collateral. This assumption is not accurate if another lender has a prior claim to the inventory. There are a number of ways for BB to guard against having an inferior claim to the inventory (the revolving credit agreement might contain negative covenants against purchase money financing, etc.) but one way to make sure that BB does not make advances against encumbered inventory is to require that the PMSI lender give it advance notice. In practice I never saw a "borrowing base" set with reference to ordinary manufacturing equipment. For equipment, the theory is that acquisition of encumbered equipment does not harm the prior lender because it merely provides an additional asset to the debtor which may be worthless (but at least does not deceive the senior lender from making additional advances).



## **IX. The special case of PMSI's in consumer goods**

A creditor need not file a financing statement to perfect a security interest in consumer goods. So, for example, if JC sold both a widget and a RED widget cover to Carl Consumer on credit (and took back a security interest to secure payment of the purchase price), JC would not need to file a financing statement to perfect its security interest--perfection would be automatic upon attachment. Automatic perfection is not, however, available for automobiles and other items subject to a certificate of title statute (for which a notation on the title document typically is required to perfect a security interest). The policy rationale for this automatic attachment rule is to save transaction costs--particularly for low priced goods it may be cost prohibitive for a creditor/seller to file a financing statement against each of its credit purchasers. Nevertheless, it would like to be able to enforce its security interest against third parties (at least in some cases--the most notable being against a bankruptcy trustee who has the status of a hypothetical lien creditor who acquires its lien at the time the bankruptcy petition is filed). The transaction cost rationale for automatic perfection does not apply when the consumer good is a high cost item such as a car or other item subject to a certificate of title statute.

[begin statute quote]

s. 9-309. SECURITY INTEREST PERFECTED UPON ATTACHMENT.

The following security interests are perfected when they attach:

(1) a purchase-money security interest in consumer goods, except as otherwise provided in Section 9-311(b) with respect to consumer goods that are subject to a statute or treaty described in Section 9-311(a);

\* \* \* [end statute quote]

Though a PMSI security interest in a consumer good is perfected automatically upon attachment, there is no prohibition against a creditor filing a financing statement against a consumer debtor in a consumer good. Indeed, making such a filing will provide enhanced protection for the creditor. To illustrate the enhanced protection provided by a UCC-1 filing in a consumer transaction, consider the case of a consumer who purchases a computer on credit. The computer is both a “good” but also includes “software”. While the security interest in the consumer good is perfected by automatic attachment, the security interest in the embedded software is not. The filing of a financing statement covering both the good and the software would perfect the combined value of what is, in essence, a unified product even though the UCC sees it as two different items of collateral—i.e. two different asset classes. Of course, a super-generic description of collateral *might* be used in the UCC-1 to cover both the good and the software (though I would want to be sure that the consumer had authorized the filing of such a broad financing statement).

If a seller of a consumer good files a financing statement against its buyer, and its buyer then sells the consumer good to a third party, the third party will not acquire the good free and clear of the security interest. If, however, the seller of the consumer good had relied solely on automatic perfection of its PMSI, then the consumer buyer may sell the good to a third party free and clear of the security interest. This rule is specified in UCC s. 9-320(b) with respect to a buyer of consumer goods. The third-party buyer of consumer goods takes free of the perfected security interest if the buyer buys:

**[begin statute quote]**

- (1) without knowledge of the security interest;
- (2) for value;
- (3) primarily for the buyer's personal, family, or household purposes; and
- (4) before the filing of a [financing statement](#) covering the goods.

**[end statute quote]**

This does not apply to a security interest in consumer goods perfected by possession.

You may think of this ability for a buyer of a consumer good to take free and clear of a security interest as applying in a “consumer to consumer” sale.

These two examples illustrate how a seller of consumer goods might benefit from the filing of a UCC-1 financing statement to perfect its security interest in consumer goods even though it has the benefit of automatic perfection upon attachment.

### **X. Conflicts between two PMSI creditors in the same collateral**

Further PMSI priority rules distinguish between a seller/creditor who extends credit to its purchaser for part of the purchase price and a lender/creditor who extends credit to enable the purchase of the same asset. As an example, suppose that GREEN Co. agreed to extend credit equal to 50% of the purchase price of the GREEN Machine to JC. JC turned to Local Bank to lend 40% of the purchase price to enable the purchase. JC paid 10% of the purchase price out of its available funds. Further suppose that both GREEN Co. and Local Bank require a security interest in the GREEN Machine as a condition to extending credit and they both properly qualify for PMSI status. How is a dispute over priority resolved between these two PMSI creditors?

The priority in the case of such a "tie" is awarded to the seller who extended credit for payment of the purchase price rather than to the third-party enabling lender. Thus, GREEN Co. would have priority in the GREEN Machine that it sold. Local Bank would have second priority in the GREEN Machine. BB would bring up the rear with third priority in the asset.

**[begin statute quote]**

s. 9-324. PRIORITY OF PURCHASE-MONEY SECURITY INTERESTS.

\* \* \*

(g) [Conflicting purchase-money security interests.]

If more than one security interest qualifies for priority in the same collateral under subsection (a), (b), (d), or (f):

(1) a security interest securing an obligation incurred as all or part of the price of the collateral has priority over a security interest securing an obligation incurred for value given to enable the debtor to acquire rights in or the use of collateral; and

(2) in all other cases, Section 9-322(a) applies to the qualifying security interests.

**[end statute quote]**

## **XI. Practical Steps to Insure PMSI Status**

### **BEST PRACTICE FOR SECURED PARTY:**

A third-party lender who seeks PMSI status for its extension of credit should not disburse funds to its debtor. Though the debtor is the "buyer" of the goods intended to be subject to the PMSI, the third-party lender should disburse funds directly to the seller of the good. It should not give the funds to the buyer/debtor and rely on the buyer/debtor to use the funds to make the purchase.

If the debtor/buyer has given a deposit or made a partial or "down" payment to the seller of the good, the third-party lender should consider funding the purchase price in its entirety. The seller could then refund the deposit or partial or "down" payment to the debtor/buyer directly. This procedure is preferable to having the third-party lender/secured party refund the debtor/obligor. The goal is to make a record which allows for the easy tracing of the third-party's loan proceeds to the purchase of the good subject to the intended PMSI.

In the case of a sale of inventory intended to be subject to a PMSI, the secured party should not wait to file a UCC-1 financing statement until delivery of the collateral. First, the timing of delivery may be uncertain and an error might be made in coordinating the timing of the filing of the financing statement. Either file as soon as the security agreement is signed or obtain authorization to pre-file the financing statement. This might be done even prior to scheduling a delivery. Retain copies of all delivery documents, invoices, purchase orders and bills of lading—and make sure they are dated so that these dates might easily be compared to the date of the UCC-

1 financing statement filing. This will allow the secured party to easily prove that it filed and perfected prior to receipt by the buyer/debtor of the goods. This will prevent a “blanket security interest” perfected by a prior secured creditor from forcing the PMSI creditor from prove its priority with oral testimony.