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PURCHASE MONEY SECURITY INTEREST...
Not Only Convenient, It's Mandatory

This article will discuss what a purchase money security interest is, why it is so important for the creditor, what the creditor must do to achieve this status, how it can be lost, and the effect of the revisions to new Article 9 coming out next year on purchase money security interests.

By Thomas E. McCurnin

For those medium to large ticket equipment lessors, the existence of a Purchase Money Security Interest ("PMSI") is not one of convenience, it is mandatory. It is essential for the lessor's own collateral base, but even more important for both securitization or for assignment.

This article will discuss what a purchase money security interest is, why it is so important for the creditor, what the creditor must do to achieve this status, how it can be lost, and the effect of the revisions to new Article 9 coming out next year on purchase money security interests.

What is a Purchase Money Security Interest?

A purchase money security interest is a security interest in specific equipment or inventory which trumps an otherwise senior blanket security interest in the same collateral. The debtor must use the proceeds of the financing to acquire specific collateral, and the secured creditor must file its UCC-1 within 20 days after the debtor receives possession of the equipment.

The typical example of the importance of the PMSI is when a debtor has an ongoing relationship with its local bank which has a blanket security interest in all of the debtors assets. The debtor decides to acquire some additional equipment and finances it with a lease. Ordinarily, that equipment would be subject to the bank's blanket lien and the equipment lessor would be in second priority. But if the equipment lessor follows some very specific procedures, it may achieve a PMSI status, and therefore may trump the bank as to this new equipment. Therefore, a properly perfected purchase money security interest trumps prior blanket liens, landlord's liens, buyers in the ordinary course, and judgment liens.

How Does A Creditor Achieve Purchase Money Security Interest Status?

First, the secured creditor must have a valid security agreement, which adequately describes the debtor and the collateral. The courts will look to see if the written description may reasonably be construed to include the secured property, and secondly, whether the parties intended that the description include that property. Therefore, the description of the collateral must be precise, and no extraneous materials will be considered in determining what comprises the creditor's security interest.

Thomas E. McCurnin *is a lawyer with the Los Angeles firm of Barton, Klugman & Oetting, and specializes in leasing and commercial law.*

The collateral must be precisely described, and the descriptions should include the make, model, and exact serial number. Those precise serial numbers, if placed in the security agreement or UCC-1 will be binding on the creditor, so absolute accuracy is essential. Many states require specific serial numbers to be contained in the security agreement, while other states allow a specific description of the equipment. Any discrepancy in the description will be construed against the creditor.

The precise name of the debtor listed in the security agreement must be perfect, and the secured creditor should include the exact corporate name, including commas. This will be especially important next year when the new Article 9 goes into effect.

Finally, the secured creditor must file a UCC-1 Financing Statement within 20 days after the debtor receives possession of the equipment. The original text of UCC §9301 (d) (2) required filing within 10 days, which was taken from the Uniform Conditional Sales Act. However, most states have extended the grace period to 20 days, although there are a few holdovers. New Article 9 will make the 20 day grace period consistent.

There are two competing definitions of when a debtor receives possession of the equipment within the meaning of UCC §9-312(4), which would start the 20 day grace period for filing the UCC-1. One line of cases applies what is referred to as the "obligation" standard, and the other utilizes what is known as the "physical control" standard. The "obligation" standard starts the grace period when the obligation was commenced. This would be the date of the acceptance of the lease. The "physical control" standard starts the grace period when the debtor has physical possession of the collateral.

Reconciling the two standards is fairly easy, and the bottom line is that the date that the debtor received the equipment, will be the start of the grace period, unless the equipment was provided to the debtor on approval. Possession begins when the debtor receives the equipment, not when installation is completed. If the equipment is part of several deliveries, then the last date upon which the equipment was delivered controls.

The bottom line on this issue is that secured creditors should file the UCC-1 Financing Statement within 20 days of either possession or within 20 days of the date of lease commencement, whichever is earlier, regardless whether an enforceable obligation exists at that time. There is no harm in filing the UCC-1 ahead of time, even prior to the obligation being incurred, or prior to the completion of delivery.

Some lessors have attempted to argue that the 20 day grace period begins when the lessee exercises its purchase option (because the lessee had no interest in the collateral until then). That argument has generally fallen on deaf ears. Assuming that the lease is a true lease and not a disguised security interest, many lessors argue that no filing is necessary at all since the lessor actually owns the equipment. While this has been successful for true leases, the equipment lessor should be absolutely sure of its true lease status. Reliance on a lease's status as a true lease is a risky gamble, and rather than risk losing a purchase money security interest status, it is simply easier to make a timely filing, because if the lease was not a true lease, then a prior blanket security interest will prevail.

The Effect of A Creditor's Failure to File Within 20 Days or Other Mistake

If a secured creditor fails to properly identify the debtor, the collateral, or fails to file within 20 days, the creditor will lose its purchase money security interest status. If there is a senior blanket security interest, a senior specific interest, or a judgment lien creditor ahead of the lessor, then that interest will trump the lessor. This may not be readily apparent to the lessor until the lessor attempts to enforce the lien, at which time it is impossible to fix the problem, so strict observance of the above legal principles is essential.

Can The Secured Party Lose an Otherwise Valid PMSI By Acts After or During Perfection?

The secured creditor can lose an otherwise purchase money security interest in 2 ways: (1) In some states, by having a blanket security interest with the PMSI, which "transforms" the otherwise valid PMSI into a mere blanket filing; or (2) By consenting to a sale and not re-filing with the new debtor's name.

The transformation rule is an antiquated rule in about a dozen states which basically holds that a secured creditor can not have both a blanket and a PMSI on the same obligation. Some courts enforce the rule from the documents alone, where there is the possibility of future advances under the documentation. Other courts require some affirmative action on the part of the secured creditor to enforce the blanket security interest, either by a re-finance or an enforcement proceeding. Other circuits hold that the purchase money status of a loan may survive refinancing.

The better view is that transformation should not occur by a refinance or enforcement due to the definition of a purchase money security interest. UCC §9-107 provides that a security interest is a purchase money security interest "to the extent that" the loan enables the debtor to purchase new property. This language("to the extent that") would be meaningless if an obligation could never be considered only partly a purchase money debt.

The "dual-status" rule, simplifies repeat transactions between the same buyer and seller.

Moreover, this approach has the positive consequence of a larger number of sales, and the net effect is no more detrimental to the buyer than if a number of purchases had been made from different vendors, financed by different obligations.

Finally, the creditor can lose its PMSI by allowing the re-sale of the collateral by the creditor or the debtor, and not re-filing against the new owner.

Losing the Priority Through Inventory Financing

Most equipment lessors do not extend credit for inventory financing. But when a lessor leases equipment to a dealer who sells similar equipment, the issue of whether the leased goods are equipment or inventory can be difficult to determine at the outset of the transaction. Unfortunately for the equipment lessor, if the equipment can conceivably be re-sold, then there is a risk that the "equipment" could be construed as "inventory". If the equipment is

inventory, then a mere UCC filing within 20 days is not enough, and the lessor could lose its priority without its knowledge. In order to achieve a PMSI in inventory, the lessor must then send an inventory financing notice to the blanket secured creditor before the equipment is delivered under UCC §9-312(3)(b).

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One method to avoid this problem is to simply know your debtor, and determine if the equipment could conceivably be construed as inventory, to provide the inventory notice as an abundance of caution.

Effect of New Article 9 on Purchase Money Transactions

Article 9 will undergo huge changes on July 1, 2002. There have been a number of changes in purchase money security interests, almost all for the better.

First, Revised Article 9 substantially rewrites the definition of PMSI although without major substantive changes. The new definition found at Revised UCC Art 9 §9-103 defines a PMSI as a securtiy interest which secures an obligation "incurred by an obligor as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in the collateral if the value is in fact so used." It is essentially the same definition as current law.

Second, Revised Article 9 standardizes the grace period for filing. It will now be 20 days across the nation.

Third, the issue of titled vehicles has also potentially been brought into the fold of the UCC. Because titled vehicles were exempt from the provisions of the UCC, there was no real way to obtain a PMSI in them, outside the department of motor vehicles in the applicable state, and hence, no grace period. The italicized legislative note following Revised UCC Art 9 §9-311 addresses an optional elimination of state law grace periods for certificate of title perfection. If adopted by the states, a PMSI in titled vehicles will be covered by the 20 day grace period.

Fourth, the status of consignments has been debated, and while formerly treated as an unsecured loan, they are now treated as a purchase money security interest, so long as the consignor timely files.

Fifth, in inventory only, a purchase money security interest remains its purchase money status to the extent that it secures another purchase money obligation for other inventory.

Sixth, software, a creditor can obtain a purchase money security interest in software that is integrated into hardware.

Seventh, the transformation rule is rejected in commercial transactions, and a creditor may have both a blanket and a PMSI, without jeopardizing its collateral. The framers apparently could not agree on the transformation rule insofar as consumer goods transactions and leaves the issue to the courts the determination of the proper rules in consumer goods transactions.

Lastly, where there is a conflict between PMSIs, the seller PMSI is given priority over a nonseller PMSI. In all other cases, competing PMSIs are ranked according to general first to file or perfect rule. Revised UCC Art. 9 §9-324(g)(1) grants priority to a PMSI supplier over a PMSI lender financing the same collateral.

In California creditors have some protection against the sale-leaseback situation. The transfer of title to the lessor will be fraudulent as against the lessee's creditors unless a notice of the sale-leaseback is recorded at least 10 days before it occurs. Cal. Civ. Code §3440-3442.

Conclusions

The purchase money security interest is absolutely essential in today's middle market and big ticket leasing transactions. The secured creditor must be ever vigilant to protect this status at both the inception of the lease and during work outs. The new Article 9 will provide greatly needed predictability and certainty in preserving this status, and will be warmly received by equipment lessors.