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PURCHASE MONEY SECURITY INTERESTS

By Barry Marks

Hopefully, this is a review but for most of us reviews of familiar legal topics actually fill in gaps we did not know existed.

The UCC gives special benefits to "Purchase Money Security Interests." When properly perfected a "PMSI" takes priority over a competing interest in the same property even if the other creditor claims under a previously-filed financing statement perfecting a "blanket" security interest. In other words, a bank filing covering "all assets, whether currently owned by borrower or acquired after the date hereof" loses out to a properly-perfected PMSI.

The reason for this should be fairly obvious: Borrowers, even those already heavily in debt, are encouraged to acquire new items financed by the vendor or a third-party lender who makes the acquisition possible.

The law only really requires two things of a lender seeking to make a purchase money financing: (1) that the financing actually be a purchase money financing and (2) that the PMSI be perfected by a filing made within 20 days after the date the borrower receives possession of the collateral.

Turning to the second of these, it is absolutely crucial that that word "possession" be read literally. Probably the most common mistake made by lenders thinking they have a PMSI is to file after the end of the 20-day period. Sometimes this is done due to sloppiness or laziness but it is often the result of a misunderstanding of the law. The 20 days does not begin to run the date the lease is signed or even the date the Acceptance Certificate is signed. It begins to run on the date that physical possession of the collateral is received by the borrower. (I admit that this is a conservative reading and some judges have been more lenient, but who wants to take the chance where the downside is loss of collateral?).

Sometimes this 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 under the lease is extended due to testing, repair, additional deliveries of necessary pieces, etc.

The UCC offers some guidance where deliveries occur in stages: 9-324 states that the 20 day period begins "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." Clear? There is also some case law indicating that taking possession as a lessee, rather than an owner/debtor is not be enough to begin the 20 days running.

What happens if there is going to be long period of testing? What is the earliest date that a UCC can be filed? Technically, a financing statement should not be filed until there is a grant of a security interest by the borrower, meaning that filing before the acceptance certificate is signed may be subject to question. Nevertheless, most commentators agree that filing early is by far safer than filing late and sometimes it is possible to obtain a letter or other authorization from the lessee to filing the financing statement in advance of the acceptance certificate, worded in such a way as to give the lender/lessor maximum comfort.

Turning to the first issue, however, is opening another Pandora's Box. A purchase money security interest, by definition, secures a loan which enables the debtor to acquire rights in or the use of [the collateral]. (This definition requires a bit of semantic calisthenics in Section 9-103(a)). This does not mean a loan that permits the debtor to retain collateral already in its possession or for which it has already paid.

Obviously, a sale-leaseback or any financing of equipment already in the debtor's possession and paid for by the debtor might not qualify for PMSI treatment. Things get more complicated when the debtor pays part of the purchase price to his vendor, either as a down payment or the first of several periodic payments. In those situations, great care must be exercised as the courts are not in agreement as to whether minimal borrower payments, reimbursed by the lender, taint the entire transaction and frustrate the PMSI argument.

The safest course is to insist that the borrower never make a down payment or treat any situation in which even a small amount of the purchase price is paid as reimbursement to the borrower rather than directly to the vendor as a sale-leaseback, requiring a UCC check and subordination or waiver by competing creditors with blanket liens. Too conservative? The riskier course of action, although one that is not entirely unjustified at least in some states, is to allow reimbursement of minimal down payments.

Finally, a word or two about inventory financing is required. There is a special procedure for PMSI's in inventory that requires a UCC check be made before initiating an inventory finance program. If the equipment qualifies as inventory (anything that is sold or rented, even on a one-time basis) the UCC must be checked and, rather than obtaining a subordination agreement, creditors with existing blanket liens in all inventory or anything the like must be notified before the collateral is delivered to the borrower. The good news is that this notice be given once every 5 years and it does not need to be specific. A notice simply stating that the lender intends to make a series of loans to the borrower that will be financed by inventory (a general description, if possible, is a good idea) should be sufficient to give PMSI benefits to the inventory financier.

The purchase money security interest is an invaluable tool for equipment financing. Like most tools, it can give a false sense of security and ruin the project if improperly used.

Barry Marks is a founding partner of Marks & Weinberg, PC. He has significant experience in dealing with virtually every type of equipment and facility lease financing, has participated in leasing financings for more than a billion dollars of equipment and is recognized throughout the industry. If you would like more cases or articles on leasing, or have any questions or comments about this Article or other leasing issues, please visit www.leaselawyer.com or contact Barry at 205-251-8303.

