

# MARKS & WEINBERG, P.C.

## DISPATCHES FROM THE TRENCHES

### MORE ABOUT INVENTORY

The last edition of Dispatches from the Trenches discussed the possibility of a lessor of vehicles being unable to rely on a lien notation on the Certificate of Title for purposes of perfection. This edition continues the theme by discussing other issues related to inventory financing.

#### *Correction and Further Discussion about Vehicles*

As discussed last time, a lien holder generally perfects its security interest in vehicles by noting its lien position on the applicable Certificate of Title. However, when the vehicles constitute inventory held for sale or lease, a lien holder may sometimes be required to file a financing statement in order to perfect its interest. The UCC provision quoted in the Article indicated that financing statements were required “during any period in which collateral is inventory held for sale or lease by a person or leased by that person as lessor and that person is in the business of selling *or leasing* goods of that kind.” Quoting UCC 9-311(d) (emphasis added).

However, late modifications to the version of Article 9 promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) for adoption in the states removed the highlighted phrase “or leasing”. Unfortunately, that revised language did not get adopted in all states and as of the date of this Article the older language is in effect in Idaho, Illinois, Louisiana, Missouri and Rhode Island.

The good news is that, in all other states, the removal of the phrase “or leasing” means that a UCC filing is not necessary if the debtor *only* leases goods of that kind but is not in the business of selling such goods. Note that the particular vehicle in question need not be held for sale by the debtor. It is sufficient if the debtor is in the business of selling similar vehicles.

Readers should consider complying with both versions of Section 9-311 in the event that either the debtor is located (for article 9 purposes) in one of the five non-uniform states listed above or the applicable Certificate of Title is issued in one of those five states. This recommendation stems from the uncertainty as to how the mandatory choice of law provisions in Sections 9-301 and 9-303 would be applied in light of the non-uniform

versions of 9-311. Special thanks to Albert Kolb of People's Capital and Leasing Corp for noticing the non-uniform language cited in the last edition of Dispatches from the Trenches about Vehicles as inventory.

### ***Special Rules for Filing a PMSI against Inventory***

When making any purchase money filings (whether or not with respect to vehicles), it is very important to understand that the purchase money security interest rules in Article 9 of the UCC that apply when perfecting a purchase money security interest in "Inventory" by filing are much different than when the underlying property constitutes "Equipment". These rules impose additional burdens on secured parties.

Basically, obtaining a pmsi in Inventory requires that: (a) the secured party file its UCC financing statement before debtor receives possession (i.e. the twenty day grace period available for pmsi's in equipment does not apply); and (b) the secured party send notices which must be received by holders of conflicting security interests within five years before the debtor receives possession of the inventory in which a pmsi is being asserted. These conditions not only require the secured party to file its financing statement much earlier than normal, they also require the secured party to conduct a UCC search to learn of conflicting security interests and to send official notices to all holders of such interests.

### ***Buyer in Ordinary Course of Business Under Revised Article §9-320(A)***

Inventory poses another risk as well. The general common law rule is that one cannot convey a better title to goods than he had. However, a few provisions in the UCC reverse this common law rule and address the broad rights that a borrower can grant to a third party with respect to inventory. These provisions generally operate to cut off certain rights a secured party would have to recover the collateral from a third party who purchased (or sometimes leased) them from the debtor. In all cases, a secured would have any and all contractual rights against the debtor provided for in the applicable documents but would not necessarily have full rights in the underlying collateral. This has the potential of leaving the secured party with what amounts to an unsecured claim for breach of contract.

Article 9 provides enhanced rights to certain parties who purchase inventory, stating: "a buyer in ordinary course of business. . . takes free of a security interest created by the buyer's seller, even if security interest is perfected and the buyer knows of its existence." A party qualifies as a buyer in ordinary course if it "buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and [such purchase is] in the ordinary course from a person . . . in the business of selling goods of that kind."

The idea is that inventory lenders expect for their debtors to sell inventory to make profits and that this rule does not adversely impact the inventory lender since the lender's interest in the inventory is not cut off by this provision until the goods are actually sold by the debtor and since the lender's security interest will continue in identifiable proceeds generated by the sale. It should be noted that many true inventory lenders finance accounts receivable as well so as to avoid risks associated with tracing proceeds of the inventory. This buyer in ordinary course rule also encourages the marketability of goods

and protects the interest of buyers who assume that they have clear title to goods they purchase from vendors in the business of selling goods of that kind.

Note that this provision will only come into play in the context of an "equipment lease" if the lease is deemed to be a "disguised lease" or a "lease intended as security" under the UCC instead of a true lease. In such a situation, the leased property would be owned by the lessee and the lessor would merely have a perfected security interest. Assuming that the lessee is in the business of selling goods of this sort, this provision of the UCC grants the lessee the right to transfer clean title to a third party even if the lessor's security interest is properly perfected. It should be noted, that even if a third party knows of the security interest, that third party would still take free of such security interest unless it knew that the sale violated the lessor's rights.

### ***Power to Transfer and Entrusting Under Section 2-403***

Section 2-403(3) of the UCC contains a similar provision often called the "entrustment provision." The pertinent part of this Section states "any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business."

The classic example is that of an owner who takes his watch to a jeweler for repairs. If the jeweler is in the business of selling watches that are both new and used, a sale by the jeweler to a buyer in the ordinary course of business will cut off the owner's right to the watch. The owner would still have a cause of action for conversion/theft against the jeweler who had the power but not the right to convey title to the buyer. The general idea here is that, in most cases, the equities between the entruster-owner and a buyer in the ordinary course are equal and that the balance is therefore tipped in favor of the later because doing so frees that marketplace and promotes commerce.

For applications of this doctrine in the leasing context, see *Carlson v. Rivera*, 382 So. 2d 825 (1980, Fla App D4) (The court found there to be an "entrustment" when a company leased an automobile to a person who is in the business of selling automobiles, thereby allowing the lessee to convey full title to a purchaser of those automobiles) and *Sumner v. Fel-Air*, 680 P. 2d 1109 (Alaska, 1984), (The court noted that a lessee with an option to purchase an airplane had been sufficiently entrusted with the plane to convey good title to a third party purchaser given that the lessee was a merchant who regularly sold used planes).

In the event the underlying transaction is a traditional loan or a "disguised security interest" or a "lease intended as security" instead of a "true lease," this entrustment provision provides the exact same protection to a third party purchaser as the previous rule above with respect to buyers in the ordinary course. This overlap occurs since the secured party/lessor would be the "entruster" in such situations. However, if the underlying transaction were a true lease, the third party would be unable to rely on §9-320 since lessor would not have any security interest to be extinguished. In that event, the third party would rely much more heavily on this entrustment provision.

***Rights of Buyers and Sublessee in Ordinary Course under Section 2A-305.***

Section 2A-305 provides problems for a lessor of inventory under a true lease. That section states that "a buyer in the ordinary course of business or a sublessee in the ordinary course of business from a lessee who is a merchant dealing in goods of that kind to whom the goods were entrusted by the lessor obtains, to the extent of the interest transferred, all of Lessor's and lessee's rights to the goods, and takes free of the existing lease contract."

This section provides a lessee who is a merchant dealing in goods of that kind with the ability to convey to a buyer or sublessee greater rights than that lessee has under the Lease. As stated by one well-respected commentator: "if an owner leases goods to a dealer and the dealer is in the business of dealing in such goods both new and used, a sale by the dealer to a buyer in the ordinary course of business will cut off the owner's rights, and a lease to a lessee in the ordinary course of business will cut off the owner's rights to the extent of the lease." Hawkland, Uniform Commercial Code Series, §2A-305:02.

Again, there is substantial overlap between this provision and Section 2-403 addressed above. Although there is more than one difference between the two provisions, a key one is that §2A-305 provides protections for "sublessees in ordinary course of business" and not merely "buyers in ordinary course." Although the term "sublessee in ordinary course of business" is not defined in the UCC, the term "lessee in ordinary course of business" means "a person who in good faith and without knowledge that the lease to him or her is in violation of the ownership rights or security interest or leasehold interest of a third party in the goods leases in ordinary course from a person in the business of selling or leasing goods of that kind . . . ."

Kenneth P. Weinberg is a founding partner of Marks & Weinberg, PC. He and co-founder, Barry Marks, have significant experience in dealing with virtually every type of equipment and facility lease financing, have participated in leasing financings for more than a billion dollars of equipment and are recognized throughout the industry. Weinberg has written *Dispatches from the Trenches* since 2002, routinely writes articles in a variety of equipment leasing and financing journals, and has participated in numerous seminars on equipment leasing issues. If you would like more cases or articles on leasing, or have any questions or comments about this column or other leasing issues, please visit [www.lease lawyer.com](http://www.lease lawyer.com) or contact Weinberg at 205-251-8307.



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