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DISPATCHES FROM THE TRENCHES

Refinancings, Consolidations and Renewals of Purchase-Money Security Interests under Revised Article 9

By Kenneth P. Weinberg

As down turns in construction, transportation and other sectors of the economy increase pressures on the financial health of some obligors, lessors/lenders may be refinancing existing debts more lately. In any event, refinancings are not uncommon, as business financing relationships are frequently continuing relationships and not just single, isolated transactions. This is one reason the Master Lease has been so popular in our industry.

This edition of Dispatches from the Trenches focuses on transactions where an existing secured loan (including, a lease-intended-as-security such as a dollar out lease) are refinanced. Historically, such transactions have raised questions about whether the original first-priority purchase money security interest survives the refinancing. Legal concepts such as *novation* and the dreaded *transformation rule* have sometimes crept up on unwary lenders to destroy their collateral position.

The driving force behind these concepts is that only the initial debt which was used to *acquire* the equipment is entitled to purchase-money priority and that any refinancing therefore destroys the purchase-money-priority. In other words a properly created PMSI could be *transformed* into a non-PMSI when a refinancing or consolidation of debts occurred.

Consider for example, the case of a lessee who is in financial difficulty and persuades the existing finance lessor under a dollar-out lease to reduce the amount of the monthly payments and extend the duration of debt. Rather than paying a lawyer to prepare an addendum, the parties accomplish this refinancing by canceling the original lease and substituting a new lease embodying the new terms. Some courts have held that the refinancing created a new loan and that since the proceeds of the loan were NOT used to *acquire* rights in the leased equipment, no purchase money security interest exists. Remember, by definition, a purchase-money security interest requires that the loan proceeds enable the debtor to acquire rights in or the use of the collateral. UCC §9-103(a)(2).

Revised Article 9 provides strong language intended to kill the transformation rule. Section 9-103(f)(3) expressly states that, in a commercial transaction, a purchase-money-security interest does NOT lose its status as such, even if . . . the purchase-money obligation has been renewed, refinanced, consolidated or restructured. Of course, a judge's actual application of such a seemingly clear rule can still result in legal complexities.

In Re: Carl Lee Jackson, 62 U.C.C. Rep. Serv.2d 84 (2007)

In this first case, the Debtor obtained purchase money financing in order to acquire a mobile home. Although this transaction involves a consumer loan (for a primary residence) and a type of collateral which in some respects falls outside of Article 9, it is one of only a handful of cases specifically analyzing the new language regarding refinancing of purchase-money security interest under the newest version of Article 9.

Although the Kansas Manufactured Home Act governs the method of perfecting a security interest this particular collateral, whether or not something creates a purchase money security interest and the impact of refinancings on such security interests is all still a matter of Article 9 of the UCC.

In the case at bar, the original lender (Original Lender) properly perfected a purchase money security interest in accordance with the applicable manufactured home act by filing a Notice of Security Interest (a NOSI) with the department of motor vehicles. The balloon payment at the end of the original loan was subsequently refinanced by the execution of a new note and security agreement but no changes were made to the NOSI. The transaction was eventually assigned to a new lender (Assignee) who later refinanced the debt. Again, no changes were made to the NOSI. When the Debtor later filed for bankruptcy, the Trustee sought to avoid the lien by arguing that the refinanced loan was not perfected. According to the Trustee, the refinancing, changes of creditors and passage of time rendered the perfecting document ineffective.

Although the Court only needed to address whether Assignee was properly perfected since any perfected secured party would trump the interests of a Trustee in Bankruptcy, it analyzed whether Assignee was entitled to purchase-money priority. According to the Court the obligation of the debtor never lost its purchase money character [and the Revised version of Article 9] expressly provides that a purchase money security interest does not lose its status as such even if the purchase money obligation has been renewed, refinanced, consolidated or restructured. *Id.* at *15-16. It is worth noting that Kansas is one of many states which rejected the transformation rule under the prior version of Article 9. As in other states, this position under prior law was a matter of case law interpretation and not specifically set forth in the statute.

The Court described the process of refinancing stating that an existing note is frequently paid by renewal or flipped and that a new or renewed note is frequently executed incorporating the balance still owing on the old note. Other times a number of old notes are consolidated into a new note. *Id.* at * 18.

According to the Court, the refinance of the balloon paying under the original Note retained its nature as a purchase-money unless the parties intended a novation. According to Kansas law, a novation is a substitution of a new debt for an existing debt

which is thereby extinguished in a novation.ö *Id.* The controlling element is the intention of the parties, and absent a clear and definite intention of the part of all concerned to extinguish the old obligation by substituting a new one, there is no novation. Under Kansas law, ða novation is never presumed and the burden is upon the party asserting a novation to establish its existence.ö Although the Trustee introduced various evidence of the intent of a novation (such as the debtor signing new documents, the new security agreement not stating that it was purchase money and the presence of a different new lender), the Court was not swayed by such elements. It is worth noting that the Court took note in the fact that the original note and security agreement were never cancelled and sent to the debtor.

The Court also noted that because the original transaction was assigned to Assignee prior to the second refinancing, they should constitute the same entity. It remains to be seen how this Court would have analyzed a situation where the refinancing lender simply paid off the first lender without first taking assignment of the original debt.

Lewiston State Bank v. Greenline Equipment, L.L.C., 61 U.C.C. Rep. Serv.2d 195 (2006)

In this case, Debtor was a company which purchased two combines and financed the acquisition pursuant to a purchase-money financing with a lender (öOriginal Lenderö). Later, Debtor borrowed additional money from another lender (öBankö) and granted Bank a security interest in all of its assets. When Debtor subsequently defaulted to Original Lender, a third Lender (öGreenlineö) paid off all the amounts owed to Original Lender and requested and received a lien release from that lender for those two items of equipment.

Greenline subsequently sold equipment to the *individual owners* of the original Debtor and the sale was financed by John Deere. John Deere properly perfected its security interest in the equipment by filing a financing statement. It is worth noting that it was not until over a month after the Original Lender was paid off that the new individual debtors financed the purchase of the equipment and granted John Deere a security interest in it. Shortly thereafter, Greenline contacted Bank to request a subordination of Bank's interest in the equipment but Bank refused.

Of course, the new individual debtors eventually defaulted and John Deere repossessed the equipment. Shortly thereafter, Bank asserted that it had a superior lien on the equipment. John Deere assigned all of its interest to Greenline and Greenline sold the equipment without notifying Bank. Bank filed a complaint for the disgorgement of the proceeds obtained from the sale.

Greenline's main argument was that, throughout the process, it retained Original Lender's purchase-money security interest in the equipment. Relying on the same language used in the *Carl Lee Jackson* case discussed above, Greenline insisted that ða purchase money security interest does not lose its status as such even if the purchase money obligation has been renewed, refinanced, consolidated or restructured.ö

The Court disagreed, noting that “Greenline, as a new creditor, satisfied and terminated the original purchase-money obligation, thereby extinguishing the PMSI. It was only after a span of time that Greenline extended new credit to [the individual debtors] in return for a security interest in the same collateral.”

Put another way, the course of events resulted in two distinct transactions after the original loan security agreement. The first transaction was in January when the first debtor was paid off. The second transaction occurred over a month later when a debtor (although related) debtor purchased the equipment from Greenline. The Court further noted that “there is nothing in the documents representing the transaction [among debtors, John Deere and Greenline] reflecting an intent to continue the effectiveness of the original lender’s PMSI. Indeed, the identity of the borrower changes from a company to individuals.”

Since the Uniform Commercial Code does not define the term “refinance”, the Court back-stopped its decision by analyzing the goals and purposes of Article 9. According to the Court, “the policies underlying Article 9 support our conclusion that the status of an original PMSI does not survive when a new creditor satisfies and terminates the original purchase money obligation and subsequently extends new credit to the debtor for security interest in the same collateral. Such a transaction contravenes a fundamental purpose of Article 9, which is to give notice to third persons and simplify the filing process.”

According to the Court “if we held, instead, that John Deere retained [Original Lender’s] PMSI, then Bank, when it executed its promissory notes and perfected its security interest, could not assume that it had priority once [Original Lender’s] PMSI was extinguished. Further, the state would have no recorded prior liens after [Original Lender’s] lien release. In addition, during the gap [of that month], any potential creditor would have no notice of Greenline’s PMSI and would enter into secured loans agreements under a false assumption of having a priority position.”

The Court’s reasoning is generally fairly sound. However, it moves further by crafting the following rule: “A PMSI may survive refinance in only two circumstances: (1) when an original creditor or (2) a creditor’s assignee, refinances a debtor’s obligation incurred to purchase the secured collateral.”

Summary and Recommendations

It is definitely a good thing that Revised Article 9 includes a provision stating that “a purchase-money-security interest does NOT lose its status as such, even if . . . the purchase-money obligation has been renewed, refinanced, consolidated or restructured.”

However, such language is not a panacea and careful thought must still be given to refinancing transactions. Consider adding language to the refinance documents which identifies the original debt documents and expressly states that the new documents constitute a refinancing, consolidation or restructuring of the debt originally evidenced by those other documents. If the refinancing lender is a different entity than the original lender, it is also prudent to take an assignment from the original lender of the original debt and the original UCC Financing Statement in connection with the refinancing. Of course, it’s always safest, if possible, to simply clear all liens through releases and subordinations prior to consummating the transaction.

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