community BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The Community Banker is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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A PREMIER ON THE PURCHASE MONEY SECURITY INTEREST

Yippee! Your bank is financing equipment for the new hotel in town, and the loan is large. A purchase money security interest (PMSI) is an exception to the First-to-File rule, giving secured creditors who meet its requirements a special advantage to jump ahead in line of other creditors with respect to certain collateral. PMSI creditors are at the top of the heap and can get super priority over third parties who perfected their interests first - as long as that lender's money was used to finance the purchase.

N.D.C.C. § 41-09-03(2)(a) (UCC § 9-103) provides that "A security interest in goods is a purchase-money security interest: To the extent that the goods are purchase-money collateral with respect to that security interest;" In other words, a PMSI is created when a bank loans money to a debtor to finance the purchase of certain goods; the debtor then grants the creditor a security interest in those goods.

There are different types of collateral in which the creditor may be able to obtain a PMSI, including inventory, non-inventory, farm products, and software. For this newsletter, we'll address more common collateral - inventory and non-inventory, which can be defined as follows:

Inventory: N.D.C.C § 41-09-02(a1)(zz) (UCC § 9-102) provides that inventory means goods that are not farm products and that are (1) leased by a person as lessor; (2) held for sale or lease or to be furnished under a contract of service; (3) furnished in connection with a service contract; or (4) raw materials, work in process, or used or consumed in a business. This includes current and future inventory.

Equipment - collateral that's non-inventory: This is a security interest taken on a specific piece of collateral where the debtor retains the equipment, for example a forklift in a warehouse, copier in an office, an exam table in a clinic, or a refrigerator in a restaurant.

I. OBTAINING A PMSI IN NO-INVENTORY COLLATERAL - EQUIPMENT

1. The Security Agreement

A. The Bank and the hotel should enter into a Commercial Security Agreement that includes

language agreeing that the hotel grants to the Bank a purchase money security interest in the equipment *and* inventory (PMSI language).

B. Because a creditor can file a PMSI financing statement *and* a blanket or wraparound financing statement on the same collateral, the Commercial Security Agreement should also have language granting the Bank a security interest in all equipment and inventory (blanket/wraparound lien).

2. **The Financing Statement**

A. The financing statement for non-inventory collateral can be pre-filed **before** the borrower takes possession of the goods. (Our preferred method.) See N.D.C.C. § 41-09-42 (UCC § 9-332).

B. The Bank also has the option of filing a financing statement covering the collateral within 20 days of the borrower receiving possession of the collateral. N.D.C.C.§ 41-09-44(1) (UCC § 9-324). If the filing takes place *after* these 20 days, the Bank won't have PMSI priority. Obtain and keep copies of all delivery documents, including copies of invoices, purchase orders, and bills of lading, *especially* if you are a lender using the 20-day perfection option. Be aware that a claimed PMSI may lose its super-priority if the date of possession is uncertain.

Description. It's not necessary to specifically describe each type of equipment subject to the PMSI – a description of collateral reasonably identifies the collateral if it identifies the collateral by category. *See* NDCC § 41-09-08(2) (UCC § 9-108). "Equipment" means goods other than inventory, farm products, or consumer goods.
N.D.C.. § 41-09-02(1)(ll). This means things used in the course of the debtor's business and is *not* stocked inventory. Accordingly, "All equipment" should be sufficient. Note that although great specificity is not required, the U.C.C. does not prohibit a creditor from providing as much detail as it may wish. *See* In re Nelson, 45 B.R. 443, 444 (Bankr. D.N.D. 1984).

If the Bank wants to be more specific, it can use language like "all equipment, including but not limited to beds, refrigerators, cash registers, swimming pool pumps, etc." However, it's a bit cumbersome to attempt to describe the thousands of pieces of equipment in use at a hotel, which is why invoices showing *what* equipment was purchased *with Bank money* are helpful.

C. No special language is required for obtaining the PMSI, but notification of your interest is the goal. For example, the Bank can notify the world in its financing statement that it claims a PMSI:

> "Secured Party hereby gives notice that it claims a Purchase Money Security Interest in all equipment leased or financed and its proceeds, including but not limited to insurance proceeds. Secured Party hereby gives notice that it claims a Purchase Money Security Interest in all inventory and its proceeds, including but not limited to insurance proceeds."

D. The Bank has the burden to show that *its money* was used to make the equipment purchases if it claims a PMSI in equipment. N.D.C.C.§ 41-09-03(7) (UCC § 9-103).

TIP: Ideally, the Bank should tender the loan proceeds directly to the seller/vendor of the equipment collateral to remove all doubt that the loan enabled the hotel to "acquire" rights in the collateral.

If the hotel has already provided a deposit or partial payment to an equipment seller, the Bank may pay the seller in full and have the *seller* refund the deposit or partial payment to the hotel rather than have the Bank refund the hotel.

E. There is no need to file another financing statement when the hotel takes possession of a type of "equipment" not described in your financing statement (if you use the "included but not limited to . . ." language) so long as it's in the "equipment" category. *See* In re Ziebarth, No. 88-05027, 1989 WL 1107877, at *3–4 (Bankr. D.N.D. Mar. 2, 1989) *quoting* In re Nelson, 45 B.R. 443, 444 (Bankr.D.N.D.1984) ("It has long been a general principal of secured transactions that the security agreement is the contract, and the financing statement has as its purpose only to reasonably identify the nature of the secured collateral such that the third party might have notice. Specificity is not required in denoting the nature and extent of the secured collateral; it is only necessary that the description as a whole provide enough information to enable a person, aided by inquiries which the instrument itself suggests, to identify the property."); *see also* In re Alexander, 39 B.R. 110, 111 (Bankr.D.N.D.1984) (concluding that "livestock, supplies, inventory, farm and other equipment" was a sufficient financing statement description); W.F. J., Inc. v. Bank of Tioga, 605 F.Supp. 39, 42 (D.N.D.1984) (concluding that "all equipment and machinery" was a sufficient financing statement description).

F. A PMSI can only exist in goods and software, and only in software to the extent the software is acquired in a transaction in which the Bank also obtains a PMSI in goods for which the software is to be used. (Example - the Bank has a PMSI in computers, cash registers, etc. and the hotel acquired its interest in the computerized check-in software and the cash register software for the principal purpose of using the software in the goods.) *See*
N.D.C.C. § 41-09-03(3) (UCC § 9-103).

G. N.D.C.C. § 41-09-03(6) (UCC § 9-103) clarifies that a purchase money security interest does not lose its PMSI status **(a)** if the purchase money collateral also secures a non-purchase money obligation, **(b)** if the purchase money obligation is secured by both purchase money collateral and non-purchase money collateral, or **(c)** if the purchase money obligation has been renewed, refinanced, consolidated, or restructured.

H. In addition to taking steps to getting a properly-perfected PMSI, if at all possible the Bank may want to get subordination agreements with those parties that have blanket or wraparound liens in the hotel collateral. That way, the Bank's PMSI will have priority over those lienholders, but **i)** it will have a separate layer of defense for its priority, and **ii)** it will have a more complete understanding of what these creditors are claiming.

Summary:

For non-inventory goods like equipment, a Bank must file a UCC-1 before the borrower takes possession of the goods or within the first 20 days after.

Describe the collateral as you would in a regular financing statement, by category.

Be sure the Bank can show *its money* was used to purchase the equipment.

II. OBTAINING A PMSI IN INVENTORY COLLATERAL

1. <u>The Security Agreement</u>

A. The Bank should also include "inventory" on its security agreement and financing statement (items stocked and sold at the hotel bar and restaurant, etc.). The rules governing obtaining a PMSI in inventory differ from those pertaining to PMSIs in other goods.

B. The Rules

A secured party can only obtain a PMSI in inventory if:

- The purchase-money security interest is perfected when the debtor receives possession of the inventory.

Note: Because there is <u>no 20-day grace period</u> and the lien must be "perfected" prior to the debtor receiving possession, the UCC-1 must be filed and the lien must attach (which means the secured party must have provided value and a written security agreement must have been executed), *prior* to the debtor taking possession of the inventory; and

- The purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest (anyone with a blanket or wraparound lien, or anyone with any lien on inventory), and the holder of the conflicting security interest receives the notification within five years <u>before</u> the debtor receives possession of the inventory; and

- 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.

See N.D.C.C. § 41-09-44(2)(a-d) (UCC § 9-324).

2. <u>Proceeds In Inventory</u>

Be aware that while a lien generally follows through to proceeds, a PMSI priority in inventory proceeds does *not* extend to accounts or cash payments received after delivery of inventory to the buyer. Inventory is expected to be sold in the ordinary course of business, and once sold, the buyer takes the inventory free of the security interest. *See* N.D.C.C. § 41-09-40 (UCC § 9-320). The PMSI holder's special priority does not "follow" into ordinary accounts or later cash collections, unlike the broader proceeds rules for non-inventory PMSIs (which get priority in identifiable proceeds generally). So, a PMSI lien in inventory will not have priority over an accounts receivable lien holder with a prior filing in "accounts." Moreover, to the extent the proceeds become money in the bank (a deposit account), a bank or any secured party with control over the deposit account will have priority over the PMSI inventory lien holder.