



Legal Alert

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QUESTION: CAN I SECURE BOTH PURCHASE-MONEY SECURITY INTERESTS AND NON-PURCHASE MONEY SECURITY INTERESTS WITH THE SAME COLLATERAL WITHOUT JEOPARDIZING THE PURCHASE-MONEY SECURITY INTEREST PRIORITY?

ANSWER: REVISED ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE ALLOWS COLLATERAL TO HAVE BOTH PURCHASE-MONEY AND NON PURCHASE-MONEY STATUS, BUT YOU NEED TO BE CAREFUL IN DOCUMENTING AND ADMINISTERING THE ACCOUNT.

Being able to take back what you sold or financed when the debtor fails to pay for it seems like common sense. Fortunately, if you take the proper steps required by Sections 9-103 and 9-324 of Revised Article 9 of the Uniform Commercial Code (U.C.C.), you can create a lien in purchase-money collateral which will have priority over conflicting security interests in the same goods.

So what is a “purchase-money” security interest? A “purchase-money obligation” is a debt incurred as all or part of the price of the collateral, or is the obligation arising from the loan made to enable the debtor to acquire the collateral. And “purchase-money collateral” means goods or software securing the sale or loan which allowed the debtor to acquire the collateral. If you sold goods to the debtor on credit or loaned the debtor money to buy the goods, you can establish a purchase-money priority security interest in those goods. In general, except as to inventory or livestock, a perfected purchase-money security interest in goods has priority over a conflicting security interest in the same goods, and in the identifiable proceeds of those goods so long as the purchase-money security interest is perfected by the time the debtor receives possession of the collateral or within twenty days after that.

You can also take a purchase-money security interest in inventory which you sold on credit or financed. As the debtor turns over its inventory in the course of business, the properly perfected purchase-money security interest does not lose its priority in the remaining inventory you sell or finance.

With respect to inventory, the priority of the purchase-money security interest extends to the same inventory, any chattel paper or instruments constituting proceeds of the inventory, and in proceeds of the chattel paper, with some exceptions. Moreover, the properly perfected purchase-money security interest in inventory will retain its priority in identifiable cash proceeds of the inventory so long as those proceeds are received on or before the delivery of the inventory to a buyer, if:

- a. the purchase-money security interest is perfected by the time the debtor takes possession of the inventory;
- b. an authenticated notification is sent by the secured party to the holder of any conflicting security interest;
- c. the holder of the conflicting security interest receives the notification from the purchase-money secured creditor within five years before the debtor obtains possession of the inventory; and
- d. the notification states that you have or expect to obtain a purchase-money security interest in the debtor's inventory and you properly describe the inventory in the notification.

So let's say you filed your UCC-1 with the Secretary of State and you perfected your security interest in the purchase-money collateral by the time the debtor received the collateral or within twenty days. Or, if you were dealing with inventory, you made sure that the UCC-1 financing statement was filed before the debtor received possession of inventory, and you sent your authenticated notification to anyone who held a conflicting security interest to let them know that within the next five years the debtor would receive possession of inventory of a certain described type in which you expected to acquire a purchase-money security interest. Now that you have a priority lien, how do you keep from losing the "purchase-money" priority?

Prior to Revised Article 9, some courts held that purchase-money security interests could lose their purchase-money character (and therefore priority) in certain circumstances. For example, if the collateral were refinanced or if the collateral secured additional non-purchase-money debt, some courts ruled that the property had been "transformed" and was no longer purchase-money collateral. Revised Article 9 now makes it clear that collateral can have both purchase-money and non-purchase-money status.

Part of the trick to maintaining your priority in "dual status" collateral is in the application of payments. In non-consumer-goods transactions, if the extent to which the security interest remains a purchase-money security interest depends on the application of a payment to an obligation, these rules must be followed:

- a. The payment must be applied in accordance with any reasonable method agreed upon by the parties.
- b. If the parties did not agree to a reasonable application method, then the payment must be applied in accordance with the intent of the obligor indicated at or before the time of payment.
- c. If the obligor has not indicated how to apply the payment and there is no agreement as to a reasonable application method, then payments are applied :
 - i. First, to obligations that are not secured; and

- ii. If multiple obligations are secured, then to the obligations which are secured by purchase-money security interests in the order in which the obligations were incurred.

For example, let's say that you sold \$50,000 worth of equipment to the debtor on ninety-day terms and properly perfected your purchase-money security interest. Now the debtor wants to borrow an additional \$10,000 from you to use in its operations and offers to secure this new loan with the collateral in which you have a purchase-money security interest. If you document this transaction properly, the security interest remains a purchase-money security interest, but only to the extent of the initial \$50,000 advance.

When the debtor makes a \$5,000 payment on the \$60,000 obligation, how much of the security interest remains a purchase-money priority security interest? Would it be \$50,000 or \$45,000? The UCC now lets the parties decide the application of these payments in their contract. But if the parties don't agree on how the payments should be allocated, then the obligor can designate how payments should be allocated. If the obligor doesn't tell you how to apply the payment or indicate its intentions, then obligations that are not secured will be paid first. Then after the unsecured debt is paid, payments are applied first toward the obligations secured by purchase-money security interests. If there is more than one purchase-money security interest, then payments are applied to the oldest obligations first.

Having a priority lien ahead of other secured parties can be a wonderful way to make sure that you get paid. In order to make sure that you obtain the purchase-money priority security interest, you need to make sure that you follow the rules with regard to the filing of financing statements, providing of notices, and the timing of these events in relation to the delivery of the goods. In order to maximize the value of your purchase-money security interest, you need to be careful as to the application of payments. Clearly, the best policy is to specifically provide in the agreement that payments will be applied in a manner designed to preserve the extent of the purchase-money priority security interest in the collateral.

We have not attempted to delve into the nuances of purchase-money security interests in consumer goods, software, or livestock in this article. Should you or someone you know need assistance with those types of collateral, or if you require assistance with the steps needed to properly perfect a purchase-money security interest, please feel free to call me.