



Better Than The Average Lien

by John Washburn, Chair, Financial Institutions Practice Group

The cartoon character Yogi Bear used to quip that he was “*smarter than the average bear*”. Although many people in business are familiar with the basic requirements for obtaining a security interest when extending credit to other businesses, they may not be aware of the options available in certain circumstances to obtain “super priority” security interests, which are “*better than the average lien*”. The two most commonly used ways in which creditors obtain a super priority lien involve “purchase money security interests” and investment property.

A. Purchase Money Security Interest. Generally, purchase money security interests (“PMSI”) are available to anyone providing financing, as a seller or lender, for the purchase of goods. “Goods” include almost all tangible personal property. Intangibles such as payment rights, contract rights and software cannot be the subject of a PMSI. In order to obtain a purchase money security interest, it is necessary to follow certain rules not applicable to plain vanilla security interests. A PMSI, if properly perfected, will have a lien superior to those of other consensual lien holders. Failure to properly perfect a lien as a PMSI will result in the “first to file rule” regarding financing statements governing priority. Since there is often a preexisting security interest already in place, failure to properly perfect a PMSI means that while you may have an ordinary security interest – it will likely be worthless.

B. Timely Filing of UCC. As would usually be the case when obtaining a normal security interest, filing a UCC Financing Statement is part of the process; however the timing of when the filing must be made is somewhat different. For PMSI’s in goods other than inventory or livestock, the preferred interest is created by making sure that the PMSI is perfected, i.e., the UCC financing statement is filed by the time the debtor takes possession of the collateral or within 20 days thereafter. With respect to inventory, the filing rule is even more restrictive because the security interest must be perfected by the time the debtor receives possession of the goods, i.e., there is no 20 day grace period for a PMSI in inventory. As a matter of law, “inventory” refers to how the debtor uses the goods – in other words – does the debtor hold the goods for sale or are they used or consumed in a business. For example, what might be inventory to one debtor could be equipment to a different debtor.

C. PMSI in Inventory. For a PMSI in inventory, in addition to filing the UCC, the purchase money secured party must send an authenticated notification to the holder of any conflicting security interests in the inventory, such notice must be received by the other secured party within five years before the debtor receives possession of the inventory in question. Such notice therefore needs to be renewed periodically if the PMSI in inventory will be ongoing for more than five years. Due to the notice requirement, creating the PMSI in inventory will require a lien search to be conducted by the creditor to determine if there are any outstanding security interests. Often times, the other security interest is a blanket lien on all assets of the debtor which is held by the bank providing a line of credit. The notice to the creditor must state that the person sending the notification has or expects to acquire a purchase money security interest in the

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inventory of the debtor and must describe that inventory. Care in describing the inventory is important as careless descriptions have been known to defeat the creditor's claim to PMSI status.

A few additional things to note with respect to inventory financing are that the PMSI will not have priority over other security interests in accounts receivable arising from the sale of the goods, but will extend to identifiable cash proceeds received on or before the delivery of the inventory to a buyer. A careful manufacturer or distributor may therefore want to require any party providing receivables financing to agree that the receivables financing will be used to pay off debt to the inventory supplier. It should be noted that the security interest in goods will generally be lost upon the sale of the goods in the ordinary course of business by the debtor to its customers. A PMSI in inventory will lose its priority but not its lien altogether in the case of "commingled" inventory used in the manufacture or fabrication of finished goods.

D. Benefit of "Control" of Investment Property. The rules regarding security interests in investment property are somewhat complicated as they involve different articles of the Uniform Commercial Code, but, if followed, will provide a super priority over liens perfected merely by the filing of the UCC financing statement. Although a security interest in investment property can be perfected by a filing of a financing statement, "control" of the investment property will give a creditor a super priority. So, for example, a creditor may have properly perfected security interest in the stock of a company. However, that security interest will lose to a creditor who actually has the stock certificates in his hands.

E. Method of Obtaining Control. The manner of obtaining control of investment property depends on the nature of the investment property. Where the property is certificated shares in a corporation or certificated interests in a partnership or a limited liability company, possession of the certificates by the secured party or its agent is required to obtain control. If certificated securities are in registered form, i.e., where the name of the borrower is on the certificate, certificates must either be endorsed to the creditor, endorsed in blank, or be re-registered in the name of the creditor for the secured party to be deemed to have control. The endorsement is often accomplished by the execution of a stock power or assignment separate from the certificate. If the certificates have not been issued, control can be obtained by the issuer agreeing in writing to follow instructions of the secured party without the further consent of the debtor. With respect to a partnership or limited liability company which issues certificates, it is usually necessary that the LLC will have elected as part of its partnership or operating agreement to be governed by Article 8 of the Uniform Commercial Code, called "opting in". If a partnership or LLC has not opted in, "control" of a partnership or membership interest will generally not be obtainable unless it is an investment company security, and in such case perfection can only be accomplished through filing a UCC financing statement in the proper filing office. The risk to the creditors of the entity not opting in at the time of the transaction is that the entity could theoretically opt in at a later date thereby creating an opportunity for another secured creditor to get control of the equity interest which has been pledged. With respect to securities held in a brokerage account, control will be obtained by either the creditor becoming the entitlement holder with respect to the account, or by an agreement in writing signed by the securities broker, the creditor, and the debtor stating that the securities broker will comply with the entitlement orders originated by the creditor without further consent of

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the debtor or any other party having acquired control of the account, acknowledging that it has control on behalf of the creditor.

In entering into a transaction where you are taking equity interests as collateral or retaining a security interest in collateral that you are selling to a business, an attorney should normally be consulted to make sure the current rules to obtain super priority status are followed. An awareness of ways to obtain a higher priority of one's security interest is important to avoid finding oneself behind the proverbial 8-ball of having a junior lien subject to a conflicting security interest. If you have questions regarding any of the above, feel free to contact John Washburn, jwashburn@gouldratner.com, or other members of the firm's Financing Group.

Mark Leipold assisted John Washburn in the preparation of this article.