

# ***PURCHASE MONEY SECURITY INTERESTS***



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## INTRODUCTION

Suppliers of goods frequently become justifiably concerned during difficult economic times about the credit risks posed by their customers. These concerns may lead to a reluctance to sell on credit, which in turn may negatively affect sales. One way suppliers can mitigate these credit risks is to employ a relatively simple security device to protect their interests, the Purchase Money Security Interest (“PMSI”). This article discusses the requirements for obtaining a PMSI under the Uniform Commercial Code (“UCC”).

Section 9-103 of the UCC defines a PMSI as a security interest in goods or software that are collateral for an obligation that arises in connection with the sale of the goods or software to the debtor. Note that a PMSI can only be taken in goods or software. This article focuses exclusively on PMSIs covering inventory. The UCC definition of “inventory” is broader than you might expect, and includes not only goods held for sale but also goods held for lease and work in process. *See* UCC §9-102(48).

The importance of a PMSI is that it provides the seller of goods on credit (“Seller”) with priority over other creditors who have a conflicting security interest in the same goods. The typical situation for Seller will be sales of goods on credit to a customer for the customer’s inventory when the customer’s primary lender already has a perfected security interest in all of the customer’s subsequently-acquired inventory (typically this will be in the form of a “blanket” security interest in after-acquired inventory, equipment, accounts receivable, furnishings, etc.). If Seller follows the very specific steps to obtain a PMSI for the goods that it is selling to the customer it will be able to trump the security interest of the other creditors. A properly perfected PMSI will have superior rights to the specific inventory the Seller is selling to that customer and to certain identifiable cash proceeds from the inventory over a conflicting security interest in the same inventory.

A Seller will want to consider taking a PMSI in goods in certain common situations. One is the sale of a large piece of equipment that Seller is financing by selling it to the buyer on credit terms.

Another is a series of sales of goods to a buyer on credit when the goods will be held by buyer for at least some period of time in inventory (*i.e.*, not immediately converted to finished goods).

### HOW TO OBTAIN A PMSI

The general rules establishing the mechanisms and priority of a PMSI are set out in UCC §9-324. In many ways, a PMSI is the same as any security interest.

Seller and its customer first must execute a security agreement, which can be part of the sales agreement. In the case of a PMSI, however, it is very important that the agreement relate **only** to the goods that will be transferred to the customer in the future. Courts have held that a security agreement that purports to cover prior debts, even if the prior debts relate to sales on credit for the customer's inventory that remain open for payment, will not result in a PMSI.

Second, the PMSI must be perfected. This is accomplished by filing the appropriate financing statements with the secretary of state or other filing agency in the state where the customer is legally organized.

Third, in order to receive priority over the customer's other secured creditors, such as its lender, the PMSI must be perfected at the time the customer receives the goods that will go into inventory. In other words, Seller must file the financing statement **before** the goods are delivered.

Fourth, the PMSI creditor must give **written notice** to the holder of the conflicting security interest if the holder of that conflicting security interest has filed a financing statement. This notice must inform the holder of the other security interest that the PMSI creditor has or expects to acquire a PMSI in certain of the debtor's inventory and must describe that covered inventory by item or type. This notice must be received by the holder of the other security interest **prior** to the debtor's receipt of the goods, and is valid for a period of five years. This means that Seller will not have to continue to provide the other creditor with this notice every time Seller advances goods to the customer on credit during this five year period.

Once Seller jumps through all of these hoops, Seller will have a PMSI for five years on goods sold to the customer after execution and perfection of the PMSI, and that PMSI will have priority over

earlier, normally superior, security interests that cover the same inventory. Armed with this special security interest, Seller will have additional remedies to assist in collecting its receivables, or will have priority to retrieve and resell goods sold on credit for which the customer failed to pay.

#### EXAMPLE

To assist in understanding the PMSI process, the following checklist works through a hypothetical example. Seller sells automotive parts to a distributor (“PartsMan”) that places those parts in its inventory and sells them to retailers. Seller’s sales to PartsMan have all been on open credit, and until recently PartsMan was paying within 45-60 days. No payments have been received within the past 120 days, however, and Seller has initiated contact with PartsMan to determine the problem. PartsMan acknowledges that it is having some financial problems related to restructuring its debt, but states that it cannot survive without the parts it buys from Seller. Seller agrees to continue to sell parts to PartsMan, but only on two conditions: (1) a promissory note for the account receivable to date, and (2) a security interest in goods to be sold in the future. Seller knows the importance of keeping these two items separate in order to permit the security interest in goods to be sold in the future to become a PMSI. Accordingly, Seller goes through the following steps:

1. Before making the next shipment of good to PartsMan, representatives of Seller and PartsMan execute a security agreement covering goods sold to PartsMan in the future and placed into inventory (as defined by the UCC) by PartsMan after the date of the agreement.
2. Seller files with the secretary of state in PartsMan’s state of organization a financing statement that attaches or specifically references the security agreement.
3. Seller searches in the UCC filings with the secretary of state in PartsMan’s state to determine if any other creditor has filed a prior financing statement that covers PartsMan’s after-acquired inventory (note: this financing statement may also cover other of PartsMan’s assets, such as accounts receivable and equipment, but we are only interested in inventory).
4. If Seller finds any other financing statements on file for PartsMan’s inventory, Seller sends a written notice to that creditor informing it that Seller has taken a PMSI in goods that will be

shipped to PartsMan and placed in PartsMan’s inventory, and that notice describes the goods either by item (*e.g.*, lists of model or serial numbers) or by type (*e.g.* 10,000 oil filters).

5. Seller puts a note in its internal “tickler” system that the notice to the other creditor expires in five years and must be renewed at that time if Seller is still selling goods to PartsMan under this arrangement.
6. Seller then ships goods to PartsMan.

### CONCLUSION

Suppliers of goods (or software) who add PMSIs to their credit and sales processes will gain a valuable tool to assist in managing credit risks. Sellers should not assume that their position *vis a vis* the customer will always be junior to the customer’s lenders, since correctly taking a PMSI gives a seller priority over such lenders with respect to the goods covered by that PMSI.

This article has been prepared by Robison, Curphey & O’Connell for informational purposes only and is not intended to provide readers with specific legal advice. Each situation is different, and a seller should consult with counsel about the applicability of a PMSI to that seller’s circumstances. The attorneys in the Business and Commercial Practice Group at Robison, Curphey & O’Connell would be happy to discuss your unique business needs with you at your convenience.

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