

# Business Credit News

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**JUNE 2014 Chairman: Mark Haley  
Johnson Oil Company**

## “Purchase Money Security Agreements”

The PMSI is one of the oldest of the many tools available in our credit “toolbox” and underutilized by the majority of most credit professionals. Still, no legal filings or tools are 100% effective. It is crucial, therefore, for a PMSI practitioner to have a good understanding of the requirements of a purchase money security interest and to maintain adequate records evidencing that those requirements have been met. Carefully drafted documents are crucial to protecting one’s filing from the attack of other creditors and/or the overzealous trustee in bankruptcy.

The Uniform Commercial Code (UCC) provides special benefits to a “Purchase Money Security Interest,” which, generally speaking, is a security interest in goods including certain software and inventory (called purchase money collateral) that secures the obligation of the buyer when incurred as all or part of the price of the collateral or when value is given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used (this is the reason it is known as a purchase money obligation).

Traditionally, purchase money collateral could only consist of inventory or “goods” but the revised version of Article 9 enacted in 2001 expanded this concept to allow purchase money priority in software, which is not embedded in the goods if the debtor acquired its interest in the software in an integrated transaction in which it acquired an interest in the goods; and the debtor acquired its interest in the software for the principal purpose of using the software in the goods. Under these rules, a purchase money security interest (PMSI) can exist in a general intangible, which is the classification of any software that is not embedded in goods.

When perfected in accordance with the terms of the purchase money rules, a PMSI takes priority over a competing interest in the purchase money collateral even if another secured party has a security interest covering that same collateral that was previously perfected under a filed financing statement (such as a senior secured lender with an all asset filing). A PMSI also will have priority over any lien creditor whose interest arises prior to the date of the PMSI filing.

The origin of the PMSI was to encourage buyers to acquire new items financed by the seller or a third-party lender that makes the acquisition possible. The theory is that the existing lender is not “hurt” in any way by granting priority to the PMSI lender because, if it weren’t for the available funds made by the PMSI seller or lender to the buyer, the purchase money collateral wouldn’t be available to the buyer.

In order to qualify as a purchase money priority, the PMSI seller/lender must follow certain rules. The rules will vary depending on whether the underlying collateral constitutes “equipment” or “inventory” under Article 9. The requirements are more involved with respect to Inventory than in standard financing transactions that involve “equipment.”

### **The Debtor has to acquire the Equipment.**

For both equipment and inventory, a purchase money security interest, by definition, requires that the proceeds “enable the debtor to acquire rights in or the use of the collateral.”

This standard is not met if the collateral is already in the buyers’ possession or for which the buyer has already paid. As such, the safest way to assure that this requirement has been satisfied is for the PMSI lender to pay the seller, if they are not the seller, directly for the goods. Reimbursing the debtor can cause problems since some courts have held that reimbursing the debtor directly means it was the debtor’s money (and not the PMSI lender’s loan) that allowed the debtor to acquire rights in the equipment and have dismissed the PMSI filing. Other cases have held that as long as the debtor’s payment to the vendor and the secured party’s reimbursement of the debtor are closely connected in time and planning, they should be viewed as part of the same transaction. This is just one example that demonstrates there is nothing “uniform” about the Uniform Commercial Code and one should always employ “best practices” when entering into a secured transaction. When acting as a third party and the buyer has made a down payment to the seller, it is best, when possible, to fund the full amount to the seller and require the seller to reimburse the buyer the down payment. This provides a document trail that the third party, did in fact, provide the funds for the purchase of the “goods”.

### **Equipment Requires Perfection Within 20 Days of Possession.**

For equipment, the PMSI seller/lender must be perfected either before or within 20 days after the date the buyer receives “takes possession” of the equipment. Remember that perfection requires both: 1.) the granting of a security interest, which includes the giving of value and the buyer having rights in the collateral; and 2.) a filed financing statement perfecting the security interest. Prior to the 2001 revisions a separate security agreement was a requirement of “perfection”. The 2001 revisions allows for the “perfection” to take place if there is language in other signed documents, such as sales and/or loan agreements, where the buyer has given the seller/lender a security interest in the “goods” being purchased.

Sometimes it is easy to determine when possession begins because the buyer signs some form of delivery receipt or the seller has written evidence of the date of delivery. However, sometimes the delivery date can be confusing, when the period between the delivery date and the date of acceptance is extended because of testing, assembly, repair, or additional deliveries of necessary items, etc. In these instances the UCC offers some guidance where deliveries occur in stages, stating that the 20-day period begins when “it would be apparent to a potential seller/lender that the buyer has acquired a sufficient interest in the goods taken as a whole.”

There is also statutory and case law indicating that taking possession as a lessee (such as under a rental agreement), rather than as an owner is not sufficient to begin the 20 days running. In particular, the UCC provides:

“[One] issue concerning the time when ‘the debtor receives possession’ arises when a person acquires possession of goods under a transaction that is not governed by this article and then later agrees to buy the goods on secured credit. For example, a person may take possession of goods as lessee under a lease contract and then exercise an option to purchase the goods from the lessor on secured credit. Under §2A-307(1), creditors of the lessee generally take subject to the lease contract; filing a financing statement against the lessee is unnecessary to protect the lessor’s leasehold or residual interest. Once the lease is converted to a security interest, filing a financing statement is necessary to protect the seller’s (former lessor’s) security interest. Accordingly, the 20-day period in [this section] does not commence until the goods become ‘collateral’ (defined in §9-102), i.e., until they are subject to a security interest.”

This addresses the situation where the lessor under a true lease finances the purchase option owed by the lessee. It basically says that the 20-day clock starts to tick once the “lease” is converted into a “secured loan.”

### **Requirements for PMSI in Inventory.**

Since inventory that is held for sale may be converted into accounts or other payment obligations, sometimes fairly quickly, and existing sellers/lenders may find that financing such inventory often rolls over from time to time, Article 9 places more stringent requirements on PMSI sellers/lenders intending to obtain a PMSI in inventory. Complying with the PMSI rules for inventory requires the following:

- The PMSI lender must conduct a UCC search against that entity to reveal all secured parties of record as of that time and review the search results to see if any existing filings cover either “inventory” or the type of goods that the PMSI seller/lender will be financing (e.g. construction equipment). If any of these filings are discovered, the PMSI seller/lender must send a PMSI notification letter to that secured party that filed that financing statement, informing them of their intention of filing a PMSI. These mailings should be sent by certified mailed so that the PMSI seller/lender can provide proof, if necessary, that the notices were sent. This notice is good for five years, the term of the UCC filing. In the event the filing is “continued” at the end of the five year term the seller/lender is required to conduct another “search” and send the notices again to any existing sellers/lenders who have a security filing in the inventory including any creditor they had notified earlier. Often sellers/lenders will simply send PMSI notices to all secured creditors revealed by the search (rather than taking the risk of operations personnel making a judgment call as to who should be notified).
- The PMSI seller/lender must have perfected the security interest (meaning there is a grant of a security interest under a signed document and a UCC financing statement filing in place) on or before the date the buyer receives possession of the inventory. The 20-day window available for equipment is not available for inventory.

If future transactions are contemplated, the PMSI seller/lender may want to word their notices along with the collateral description on their financing statements broadly so as to avoid having to repeat the foregoing each time. The important aspect of the wording of the collateral description on the filing and notices is that the “goods” and/or “inventory” is being purchased from the “seller”. Article 9 does not provide much guidance as to what constitutes a sufficient description of collateral in the notice. However, it is important to understand that its purpose is simply to place the other creditors on notice of the PMSI seller/ender’s potential interest, thereby allowing them the opportunity to contact the PMSI seller/lender for more detail. That being said, given the very general description requirement under revised §9-504 for financing statements, a general description should be sufficient because it will put the existing seller/lenders on notice that another creditor may have a claim to some of the debtor’s inventory. Any conscientious existing seller/lender will investigate and obtain from the new PMSI seller/lender the nature of the specific goods in which they have a PMSI. Further, it seems unreasonable to require a specific description of the inventory in which they have an interest, especially given that the statute provides for the notice to be “good” for five years. Many PMSI seller/lenders provide a very broad description (anything it sells and/or finances) and, if possible, a slightly more narrow one (“including, without limitation, construction equipment or various diggers, cranes, lifts, drills, and other accessions, attachments or additions to vehicles”). For a captive finance company or seller of goods, it is easier to craft a notice, which identifies goods of every kind, nature, and description manufactured or sold by its vendor affiliate(s).

Finally, another requirement that a PMSI seller/lender needs to take notice is that they have a perfected interest when goods are first possessed by its debtor. This requirement is tricky in some industries (especially for some traditional equipment leasing companies).

As long as the UCC filing is broad enough to cover future schedules and unlisted goods that are later subject to those schedules, it should be relatively easy to avoid the timing problem with respect to the UCC filing after the first transaction. However, equipment lessors still need to have the grant of a security interest effective when the goods are delivered. Some equipment finance agreements and leases intended as security contain wording that show the lease to commence and the security interest granted after delivery and inspection. This technical glitch could theoretically cause problems and the safer approach is to have the grant effective upon delivery.

**In Conclusion**

The PMSI is a useful often overlooked tool in the creditors’ toolbox. While no legal or tools are 100% effective, it is crucial for a PMSI seller/lender to have good knowledge of and understanding of the requirements of a purchase money security interest and to maintain adequate records evidencing that those requirements have been met. Carefully drafted documents and diligently formulated procedures will assist in the reduction of the inherent risk in the credit transaction.

*David Balovich is an accomplished author and public speaker. He is presently the North Region credit manager for Holt Cat.*

***This and other topics will be discussed at the Credit & Collections Seminar, June 19<sup>th</sup> 2014, at The Petroleum Club in San Antonio TX. If you haven’t registered yet please give us a call at (210)225-7106.***

\*\*\*\*\* **JUNE 2014** \*\*\*\*\*

Day	Date	Group	Location	Time
Tues	3	Austin Construction	Texas Land & Cattle, 6007 N IH 35 & Hwy 290, Austin TX	11:30
Tues	10	Coastal Bend Group	Holt Cat, 1325 South Padre Island Dr, Corpus Christi TX	11:30
Wed	11	Rio Grande Group	Victoria Palms Resort, 602 N. Victoria Rd. Donna TX	11:30
Thurs	12	SW Food Credit Group	Las Palapas, 4802 Walzem Rd, San Antonio TX	11:00
Tues	17	Austin Construction	Texas Land & Cattle, 6007 N IH 35 & Hwy 290, Austin, TX	11:30
Wed	18	Victoria Credit Group	Sky Restaurant, 236 Foster Field, Victoria TX	11:30
Fri	20	SW Electrical Group	The Onion Creek Country Club, Austin TX	11:30
Tues	24	SA Construction	Las Palapas, 4802 Walzem Rd, San Antonio TX	11:30
Wed	25	Laredo Credit Group	The Laredo Country Club, Laredo TX	11:30
Thurs	26	Austin Ad Media	Teleconference Meeting 1-800-791-2345	2:00
Thurs	26	Fuel & Lube/Heavy Eq.	Teleconference Meeting 1-800-791-2345	2:30
Thurs	26	HVAC Credit Group	Texas Air Products, 11122 Gordon Rd, San Antonio TX	11:30

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Did you know you could go on-line to get the legal list bulletin? You can download legal information (mechanic liens, state, and federal liens, suits, bankruptcies, abstract of judgments, etc) on any of the following counties: Travis, Williamson, Hays, Cameron, Hidalgo, and Bexar. To access go to our web site at [www.nacmtx.com](http://www.nacmtx.com) . All you have to do is go to NACM Online, enter your membership information and make selection under Legal Bulletin. It will bring you to the legal information you need. Select the county, type of legal information and the time period requested. Type in the word **all** at the search information box. Also, you can type in the business name to receive all legal information on that specific company. For help on how to use the legal bulletin on-line give us a call at (210)225-7106.

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