



## Failure to Send PMSI Notice Costs Secured Party Priority

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The purchase-money security interest (“PMSI”) is a valuable risk management tool for commercial lenders. A perfected PMSI takes priority over conflicting security interests in the same collateral. To obtain the benefits of a PMSI, the secured party must comply with some special requirements found in UCC Section 9-324.

In many cases, Section 9-324 merely requires the PMSI secured party to file its financing statement before the debtor receives possession of the collateral or within 20 days. However, if the collateral consists of inventory, the secured party must both file to perfect and send a notice to all holders of conflicting security interests in the inventory before the debtor receives possession of the collateral. Failure to comply with both the perfection and notice requirements can prove costly.

A recent case illustrates the potential risk of non-compliance with the statutory PMSI requirements. In *Bank of Lincoln County v. GE Commercial Distribution Finance Corporation*, 2010 U.S. Dist. LEXIS 116028 (E.D. Tenn., Oct. 29, 2010), the debtor borrowed money to establish a business selling horse trailers. In exchange for the loan, the debtor granted the predecessor in interest of GE Commercial Distribution Finance (“CDF”) a security interest in its current and after-acquired inventory. CDF perfected its security interest by filing a financing statement with the Tennessee Secretary of State.

Some time after CDF perfected its security interest, Bank of Lincoln County (“BLC”) provided a loan to the debtor for the purchase of used horse trailers. The debtor granted BLC a purchase-money security interest in the inventory of used trailers. BLC then filed its financing statement with the Tennessee Secretary of State. However, BLC never sent a PMSI notice to CDF.

By January 2009, the debtor was in default on the obligation to CDF. The debtor voluntarily surrendered some of the trailers to CDF. The surrendered trailers did not include any of the used trailers that were subject to BLC’s purchase-money security interest. The debtor later filed for bankruptcy.

As part of the bankruptcy proceedings, CDF and BLC each sought a declaratory judgment that it held the superior security interest in the horse trailers financed by BLC. CDF argued that BLC was not entitled to purchase-money priority because it failed to send the required notice. However, BLC claimed that CDF never intended to take a security interest in the used trailers and that CDF waived its interest when it repossessed some of the inventory, but not the disputed trailers.

The court first had to determine whether the used trailers financed by BLC were within the scope of CDF’s security interest. After a review of the relevant provisions of the security agreement, the court found that the language unambiguously covered all after-acquired inventory without regard to its status as new or used. However, BLC claimed that CDF established a course of dealing that showed its security interest applied only to the new trailers.

As evidence of a course of dealing, BLC maintained that whenever new trailers were sold, the proceeds were paid to CDF. In contrast, whenever the debtor sold used trailers, it paid the proceeds to BLC. The court, however, rejected the course of dealing argument because it was the debtor’s unilateral conduct that determined where the proceeds of the new and used trailers were applied. In fact, the court observed that it was questionable whether CDF even had a



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right to object to the debtor's application of the proceeds from sale of the inventory. The court concluded that CDF's failure to object did not establish a course of dealing. Therefore, the court held that CDF's security interest extended to all the new and used inventory of trailers.

Having established the scope of CDF's security interest, the court next had to determine which party had priority. BLC argued that CDF relinquished its priority in the collateral because CDF was over-secured and knowingly failed to exercise its right to repossess the disputed inventory. However, BLC offered no evidence to show that CDF deviated from reasonable business practices by repossessing the new trailers first. In fact, the court observed that it would make sense for CDF to dispose of the most saleable trailers first. Consequently, the court held that CDF's security interest had priority over the interest of BLC in the disputed inventory of horse trailers.

The important thing to remember about this case is that the secured party will have difficulty convincing a court that it deserves PMSI priority if it fails to fully comply with the notice requirements specified in UCC Section 9-324. When the collateral consists of inventory, the secured party must both file to perfect and provide the required notice before the debtor receives possession of the inventory.

The party claiming a PMSI bears the burden of proving compliance with the notice requirements. Therefore, secured parties must be sure to send the necessary notices and obtain proof of delivery before the debtor receives possession of the inventory. Otherwise, the secured party can find itself denied the benefit of PMSI priority.

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