community BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The Community Banker is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

DISCLAIMER

The Purchase Money Security Interest (PMSI)

Your bank is financing equipment for the new hotel in town. In order to obtain a "super priority" in the collateral, you know you must file a purchase money security interest ("PMSI"). A PMSI gives a specific lender a right to property or its full cash value before any other creditor — as long as that lender's money was used to finance the purchase.

This also provides a defense to any attack by a bankruptcy trustee under a preference claim in the event of a bankruptcy filing by the debtor within 90 days of delivery of the collateral. How is this accomplished?

The Security Agreement

A. The Bank and the hotel should enter into a Commercial Security Agreement that includes language agreeing that the hotel grants to the Bank a purchase money security interest in the equipment and inventory (PMSI language).

B. Because a creditor can file a PMSI financing statement and a blanket or wraparound financing statement on the same collateral, the Commercial Security Agreement should also have language granting the Bank a security interest in all equipment and inventory (blanket/wraparound lien).

The Financing Statement

A. The financing statement for non-inventory collateral can be pre-filed **before** the borrower takes possession of the goods. (Our preferred method.)

B. The Bank also has the option of filing a financing statement covering the collateral within 20 days of the borrower receiving possession of the collateral. NDCC§ 41-09-44(1). If the filing takes place *after* these 20 days, the Bank won't have PMSI priority. Obtain and keep copies of all delivery documents, including copies of invoices, purchase orders, and bills of lading, *especially* if you are a lender using the 20-day perfection option. Be aware that a claimed PMSI may lose its super-priority if the date of possession is uncertain.

Description. It's not necessary to specifically describe each type of equipment subject to the PMSI – a description of collateral reasonably identifies the collateral if it identifies the collateral by category. *See* NDCC § 41-09-08(2). "Equipment" means goods other than inventory, farm products, or consumer goods - it's used in the course of the debtor's business and is *not* stocked inventory. Accordingly, "All equipment" should be sufficient. Note that although great specificity is not required, the U.C.C. does not prohibit a creditor from providing as much detail as it may wish. *See* In re Nelson, 45 B.R. 443, 444 (Bankr. D.N.D. 1984).

If the Bank wants to be more specific, it can use language like "all equipment, including but not limited to beds, refrigerators, cash registers, swimming pool pumps, etc." However, it's a bit cumbersome to attempt to describe the thousands of pieces of equipment in use at a hotel, which is why invoices showing what equipment was purchased with Bank money are helpful.

C. No special language is required for obtaining the PMSI, but notification of your interest is the goal. For example, the Bank can notify the world in its financing statement that it claims a PMSI:

> "Secured Party hereby gives notice that it claims a Purchase Money Security Interest in all equipment leased or financed and its proceeds, including but not limited to insurance proceeds. Secured Party hereby gives notice that it claims a Purchase Money Security Interest in all inventory and its proceeds, including but not limited to insurance proceeds."

D. The Bank has the burden to show that *its money* was used to make the equipment purchases if it claims a PMSI in equipment. NDCC§ 41-09-03(7).

TIP: Ideally, the Bank should tender the loan proceeds directly to the seller/vendor of the equipment collateral to remove all doubt that the loan enabled the hotel to "acquire" rights in the collateral. If the hotel has already provided a deposit or partial payment to an equipment seller, the Bank may pay the seller in full and have the *seller* refund the deposit or partial payment to the hotel rather than have the Bank refund the hotel.

E. There is no need to file another financing statement when the hotel takes possession of a type of "equipment" not described in your financing statement (if you use the "included but not limited to . . ." language) so long as it's in the "equipment" category.[1]

F. A PMSI can only exist in goods and software, and only in software to the extent the software is acquired in a transaction in which the Bank also obtains a PMSI in goods for which the software is to be used. (Example - the Bank has a PMSI in computers, cash registers, etc. and the hotel acquired its interest in the computerized check-in software and the cash register software for the principal purpose of using the software in the goods.)

The Bank may not obtain a PMSI in software in a solely software transaction. That filing would describe the collateral as "software" and it is subject to the regular first-to-file priority.

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[1] *See* In re Ziebarth, No. 88-05027, 1989 WL 1107877, at *3–4 (Bankr. D.N.D. Mar. 2, 1989) *quoting* In re Nelson, 45 B.R. 443, 444 (Bankr.D.N.D.1984) ("It has long been a general principal of secured transactions that the security agreement is the contract, and the financing statement has as its purpose only to reasonably identify the nature of the secured collateral such that the third party might have notice. Specificity is not required in denoting the nature and extent of the secured collateral; it is only necessary that the description as a whole provide enough information to enable a person, aided by inquiries which the instrument itself suggests, to identify the property."); *see also* In re Alexander, 39 B.R. 110, 111 (Bankr.D.N.D.1984) (concluding that "livestock, supplies, inventory, farm and other equipment" was a sufficient financing statement description); W.F. J., Inc. v. Bank of Tioga, 605 F.Supp. 39, 42 (D.N.D.1984) (concluding that "all equipment and machinery" was a sufficient financing statement description).

G. NDCC section 41-09-03(6) clarifies that a purchase money security interest does not lose its PMSI status **(a)** if the purchase money collateral also secures a non-purchase money obligation, **(b)** if the purchase money obligation is secured by both purchase money collateral and non-purchase money collateral, or**(c)** if the purchase money obligation has been renewed, refinanced, consolidated, or restructured.

H. In addition to taking steps to getting a properly-perfected PMSI, the Bank should where possible get subordination agreements with those parties that have blanket or wraparound liens in the hotel collateral. The Bank's PMSI will have priority over those lienholders, but **i)** it will have a separate layer of defense for its priority, and **ii)** it will have a more complete understanding of what these creditors are claiming.

Summary:

► **For non-inventory goods like equipment, a Bank must file a UCC-1 before the borrower takes possession of the goods or within the first 20 days after.**

► **Describe the collateral as you would in a regular financing statement, by category.**

► **Be sure the Bank can show its money was used to purchase the equipment.**