The Transactional Lawyer

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PMSI Notification: What to Say & How to Say It

Stephen L. Sepinuck

A creditor taking a purchase-money security interest ("PMSI") in inventory can obtain priority over a secured party with an earlier filing against the inventory if the PMSI creditor complies with the several requirements of UCC § 9-324(b). One of these requirements is that the PMSI creditor send to the earlier filer an authenticated notification stating that the PMSI creditor "has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory." A recent case, *In re Sports Publishing, Inc.*, 2010 WL 750008 (C.D. Ill. 2010), provides some guidance on the form this notification must take. A recent newsletter article discussing what the notification need say offers some sound conclusions but questionable advice. After discussing both of these authorities, this article offers a form notification for lenders to use.

The Case

In 2001, Sports Publishing LLC borrowed from Strategic Capital Bank, which obtained a security interest in the debtor's inventory. Strategic perfected its interest by a proper filing, which Strategic continued in 2006.

In 2005, InnerWorkings financed the debtor's acquisition of some books. The agreement contained language granting a PMSI in the books purchased. The language appeared on the first page, in the fourth or fifth paragraph and not under its own heading. InnerWorkings filed a financing statement and sent the security agreement to Strategic. InnerWorkings provided no other notification of PMSI financing to Strategic.

The bankruptcy court ruled that Strategic had priority and InnerWorkings appealed. InnerWorkings argued that it had provided notification to Strategic of its planned PMSI financing, both through a copy of the security agreement and through discussions with Strategic.

The Court's Decision

The district court ruled that strict compliance with the authenticated notification requirement of § 9-324(b) is necessary to obtain PMSI priority, and seemed to have three problems with InnerWorkings' effort to comply. First, the security agreement that InnerWorkings had sent to Strategic did mention the words "purchase-money security interest" but those words, the court noted, appeared in a single sentence "buried in the middle and not under any section header." Thus, in the language of the court, the words, "would not jump out or alert a party to the presence of a possible PMSI."

Second, the court noted – as if it were a different point – that InnerWorkings had not provided proof of an authenticated notification. It is unclear what the court meant by this statement. The court may have been suggesting that a copy of the security agreement can never constitute the required notification. Alternatively, the court may have been saying that the copy of the security agreement was either not authenticated at all or was authenticated only by the debtor, as would be typical of a security agreement, whereas the PMSI notification should be authenticated by the PMSI creditor.

Finally, the court added that the security agreement provided to Strategic referred to a PMSI in "goods," not "inventory."

The Moral

All of the court's concerns can easily be dealt with by a notification that: (i) states conspicuously that the sender will be taking a PMSI in inventory; (ii) describes the inventory; and (iii) is authenticated by the sender. How specifically must the notification describe the inventory? That brings us to the newsletter.

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The Newsletter

A well-regarded newsletter recently contained an article on how specifically the PMSI notification must describe the inventory. 27 CLARKS' SECURED TRANSACTIONS MONTHLY 5 (March 2011). The article states that while a super-generic description (*e.g.,* "all personal property" or "all property of the debtor financed by Supplier") would *not* be adequate, the inquiry-notice philosophy underlying Article 9 in general and UCC § 9-108 in particular should apply to PMSI notifications.

There is much to be said for the newsletter's suggestion that a PMSI notification need be no more specific than "inventory" when describing the PMSI collateral. Such a position is certainly consistent with the view that Article 9's filing system is designed to provide merely inquiry notice, not detailed information. It is also consistent with the one case on the issue, *In re Southern Vermont Supply, Inc.*, **58 B.R. 887** (Bankr. D. Vt. 1986) (decided under the very similar language of old § 9-312(3)(d) (requiring the notification to "describe[] such inventory by item or type"). Finally, a PMSI notification is good for five years and is supposed to be able to encompass multiple transactions. If the notification must list the inventory with specificity, the PMSI lender may have to send a separate notification for many of the transactions, thereby creating an unnecessary burden.

However, it is worth examining the precise language of § 9-324(b). It requires that the notification state "that the person sending the notification has or expects to acquire a purchase-money security interest in the inventory of the debtor and describes the inventory." If the notification needed to be no more specific than "inventory," there would be no need for the last four words of the provision.

In addition, it is worth noting that § 9-108(b) provides rules on descriptions of "collateral" whereas § 9-324(b) requires a description of the PMSI "inventory." Section 9-108 states that a description of collateral is sufficient if the collateral is identified by a UCC classification, such as "accounts" or "equipment." Accordingly, § 9-108 is clearly relevant to all the Article 9 provisions that require a description of *collateral*. *See* UCC §§ 9-504, 9-509(b)(1), 9-613(1)(B). But § 9-324(b) and (d) – dealing with inventory and livestock, respectively – are the only provisions of Article 9 dealing with perfection or priority that require a description of a particular *type* of collateral, and neither uses the word "collateral." Thus, it is at least arguable that a PMSI notification must contain a more specific description than "inventory."

This is not to say that a court should so rule. However, the mere fact that a contrary interpretation is plausible indicates that PMSI financiers would be well advised to be more specific than simply saying "inventory." A listing of the types of inventory covered, such as the following, would certainly suffice:

> Air conditioners, dehumidifiers, convectors, unit heaters, heating equipment, ranges, refrigerators, washers, ironers, dryers, dishwashers, sewing machines and other domestic and commercial appliances or the like and accessories and replacement parts for any such merchandise, and the proceeds thereof.

See Fedders Financial Corp. v. Chiarelli Bros., Inc., **289 A.2d 169** (Pa. Super. Ct. 1972). If the security agreement contains such a listing, the notification could simply copy that language. Alternatively, describing the inventory by its source should also be sufficient. For example, if the PMSI secured party is a seller retaining a security interest in goods sold to the debtor, describing the inventory as goods to be sold to the debtor by the PMSI secured party should be adequate. After all, the purpose of the notification requirement is to alert the prior filer to not lend against or rely upon inventory that is or might be subject to a PMSI. If the debtor presents to its regular inventory lender invoices from a seller, and the seller has previously sent a PMSI notification that describes the inventory as goods to be sold by the seller, the notification will certainly have served its purpose.

NOTIFICATION OF PURCHASE-MONEY SECURITY INTEREST

[date]

To: [Filer]

Please be advised that the undersigned will be taking a purchase-money security interest in inventory of [Debtor]. That inventory will include the following:

____

____

[PMSI Secured Party]

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Setting Standards under Sections 1-302 and 9-603

Scott J. Burnham

The UCC is sometimes regulatory, sometimes facilitatory, and sometimes both. Section 1-302(a) states the basic freedom of contract principle, generally allowing the parties to vary the effect of provisions. The first sentence of § 1-302(b) initially takes away that freedom with respect to "the obligations of good faith, diligence, reasonableness, and care." But the next sentence restores some of that freedom, with an important restriction. The parties are allowed to "determine the standards by which the performance of those obligations is to be measured if those standards are not manifestly unreasonable."

Of course, the UCC does not explain what makes a standard "manifestly unreasonable." The UCC methodology is to have the meaning of such vague terms determined contextually by either the trade or the courts. As far as the trade goes, Official Comment 1 points out that "[i]n this connection, Section 1-303 incorporating into the agreement prior course of dealing and usages of trade is of particular importance." The ULA Model Forms suggest the following language:

> **Clause Adopting Standards of Good Faith, Diligence, Reasonableness, and Care.** Unless expressly provided otherwise herein, compliance with or observance of the standards set forth in the [list of any applicable industrial, commercial, financial or other group whose customs, code of ethics or like standards are generally recognized and which are acceptable to the parties] shall constitute the observance of good faith, diligence, reasonableness and care with respect to the matters covered thereby.

4 U.L.A. 24 Form 2 (2007).

This essay examines the extent to which the courts have permitted the parties in a UCC transaction to determine the standards, and provides a bit of advice as to what "manifestly unreasonable" means in the process. A number of these cases come from Article 9, for while § 9-602 contains a lengthy list of rights and duties that may not be waived or varied, § 9-603 contains a provision analogous to § 1-302, permitting the parties to agree to "standards measuring the fulfillment of the rights of a debtor or obligor and the duties of a secured party under a rule stated in Section 9-602 if the standards are not manifestly unreasonable." One important exception – § 9-603(b) expressly provides that the parties may not determine standards for what constitutes breach of the peace.

In a number of the reported cases, the court did not have to analyze whether the standards were manifestly unreasonable because the parties neglected to adhere to the agreed-upon standards. This could be quite a setback for the creditor. For example, § 9-610(a) provides that a creditor must provide notification of disposition within a reasonable time; § 9-610(b) then provides that 10 days' notice is a safe harbor. Assume the parties agree in advance to 8 days' notice. If the creditor gave 8 days' notice, then it would only have to prove that this standard was not manifestly unreasonable. But if the creditor failed to comply with its own agreement by giving 7 days' notice, then it would not get the benefit of either the statutory safe harbor or the agreed-upon safe harbor.

At one extreme are provisions that simply negate the UCC obligation. For example, if a security agreement provided that the creditor had the right on default to immediately retain the collateral, it would seem that a court could strike the provision as violating § 9-602 without even attempting to determine standards. But in *Morgan Buildings and Spas, Inc. v. Turn-Key Leasing, Ltd.*, **97 S.W.3d 871** (Tex. App. 2003), the Texas appellate court thought it should at least determine whether such a provision was manifestly unreasonable under the former UCC equivalent of § 9-603. For that purpose, it looked to the definition of *manifest* in *Black's Law Dictionary*, which is "evident to the senses, especially to the sight, obvious to the understanding, evident to the mind, not obscure or hidden, and is synonymous with open, clear, visible, unmistakable, indubitable, evident, and self-evident." Under that standard, the surrender of rights was found to be manifestly unreasonable.

Moving from the extreme, a more typical approach is found in *Orix Credit Alliance, Inc. v. East End Development Corp.*, **688 N.Y.S.2d 191** (App. Div. 1999), where the security agreement contained "provisions concerning prior notice to the debtors of the public sale of the collateral, prior newspaper advertisement of the sale, and mandatory terms of purchase at a public sale." The New York Appellate Division first articulated the purpose of the former UCC equivalent of § 9-602 as "prohibiting agreements which relieve secured creditors from virtually all responsibility with respect to the collateral." It then determined that the agreed standards of commercial

reasonableness did not effectively leave the creditor free of those duties. Therefore, they were not manifestly unreasonable. This is a sound approach, which recognizes that there are many reasonable ways to perform a particular task.

In *Leonia Bank PLC v. Kouri*, **730 N.Y.S.2d 501** (App. Div. 2001), the parties after default agreed that the creditor had an option to purchase pledged artwork from a guarantor at certain prices. Even though the option was exercised more than two years later, the New York Appellate Division found that the agreement was not manifestly unreasonable, since "both debtor and creditor were protected against subsequent fluctuations in value." In *Ford Motor Credit Co. v. Soloway*, **825 F.2d 1213** (7th Cir. 1987), Ford foreclosed on the inventory of a dealership. The security agreement provided that a private sale in which Ford solicited bids from at least three dealers, and accepted the highest bid, was commercially reasonable. Applying Illinois law, the Seventh Circuit upheld this standard, stating that "[w]here a security agreement deems a particular means of disposing of the collateral to be commercially reasonable, then compliance with that provision is strong evidence that the secured party's disposition of the collateral was commercially reasonable."

If the creditor plans to dispose of the collateral through an unusual method, such as an eBay auction, it is advisable to obtain the debtor's agreement. Ed Smith suggests this clause:

> To the extent that applicable law imposes duties on the Lender to exercise remedies in a commercially reasonable manner, the Company acknowledges and agrees that it is not commercially unreasonable for the Lender . . . (h) to dispose of Collateral by utilizing Internet sites that provide for the auction of assets of the types included in the Collateral or that have the reasonable capability of doing so, or that match buyers and sellers of assets.

Michael Korybut, *Using an Online Auction to Sell Article 9 Collateral*, **61 Consumer Fin. Law Q. Rep. 792**, 802 (2007).

Conclusion

It appears that, at least in Article 9, courts are quite tolerant of the parties' attempts to agree to standards that measure UCC obligations as long as the standards do not effectively negate the function of the UCC rule. If a creditor contemplates an action that may be questionable after the fact, it would be prudent to provide in the agreement that that the parties agree that the standard is commercially reasonable. Then follow the standard.

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Does the Security Agreement Effectively Grant a Security Interest?

Linda J. Rusch

Like it or not, Article 9 does not control all issues that may arise in attempting to obtain a security interest in the debtor's rights. While a lawyer starts with the requirements stated in U.C.C. § 9-203, which provide that a security interest is created when the debtor has rights in the collateral or power to transfer rights in the collateral, the debtor has authenticated a security agreement with an adequate collateral description, and value is given, that is often not the whole story. In addition, § 9-109(c) and (d) provide that as to certain types of collateral and transactions, Article 9 will not apply, and thus other law will provide how to obtain a lien interest in those situations.

Even as to a transaction that is within the potential scope of Article 9, the cases on liquor licensing have taught that the careful lawyer has to consider whether the debtor's right constitutes "property." *See In re Jojo's 10 Restaurant, LLC*, **2011 WL 1984529** (Bankr. D. Mass. 2011) (no security interest can attach to Massachusetts liquor license without state approval); *Bischoff v. LCG Blue, Inc.*, **2009 WL 148519** (Cal. Ct. App. 2009) (under California law no security interest can attach to a liquor license); *Banc of America Strategic Solutions, Inc. v. Cooker Restaurant Corp.*, **2006 WL 2535734** (Ohio Ct. App. 2006), *appeal denied*, 861 N.E.2d 144 (Ohio 2007) (no security interest can attach to an Ohio liquor license because such a license is not property under Ohio law); *In re Chris-Don, Inc.*, **367 F. Supp. 2d 696** (D.N.J. 2005) (liquor license is not property to which a security interest can attach in New Jersey).

Assuming the debtor's right would be personal property, a recent case reminds us that there is yet another step in the analysis to determine whether an enforceable security interest has been created: consideration of other state or federal statutes or

common law doctrines that provide that rights in that particular type of personal property are not transferable.

In *Inliner Americas, Inc. v. Macomb Funding Group, L.L.C.*, 2010 WL 2853886 (Tex. Ct. App. 2010), the collateral was described as "to the maximum extent same are assignable pursuant to the terms thereof all. . . causes of action. . . [and] [a]ll products and proceeds of any and all of the foregoing Collateral." The cause of action at issue was the debtor's cause of action for legal malpractice. The court found that allowing assignments of legal malpractice causes of action was against Texas public policy. Having found that there was no enforceable security interest in the legal malpractice cause of action, the court went on to hold that the proceeds of settlement of that action were also not collateral as described in the security agreement. Because the cause of action was not assignable and the collateral description held that the collateral consisted of causes of action "to the maximum extent assignable," the settlement of the cause of action was not proceeds of collateral as described.

The lesson for the transactional lawyer is to remember that there is yet another step in the analysis of creating an enforceable security interest: is there some restriction outside of Article 9 that would prevent a debtor from transferring rights in the debtor's personal property or other valuable rights? If so, the transactional lawyer should consider how the property or rights should be described so that a security interest will attach to the debtor's rights that are transferrable.

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Recent Cases

SECURED TRANSACTIONS

In re Salander O'Reilly Galleries,
2011 WL 2837494 (Bankr. S.D.N.Y. 2011)
Law of New York, where debtor was located, governed the effect of debtor's consignment agreement, not the foreign law chosen in the parties' agreement. As a result, clause in agreement calling for arbitration under the law of the Channel Islands would not be enforced.

In re EEE Auto Sales, Inc.,
2011 WL 2078544 (Bankr. E.D. Va. 2011)
Amounts auto dealer collected from buyers for sales taxes and registration fees were not proceeds of the dealer's inventory.

In re PTM Technologies, Inc.,
2011 WL 2883312 (Bankr. M.D.N.C. 2011)
Financing statements that omitted the "h" in the debtor's name and which were not disclosed in a "standard" web search but were disclosed in a "non-standard" web search were ineffective to perfect because the filing office's rules provide for an exact word match (while ignoring certain "noise" words) and the "standard" search is the one that follows these rules.

COMMERCIAL CONTRACTING

AmerisourceBergen Drug Corp. v. Ciolino Pharmacy Wholesale Distributors, LLC,
2011 WL 2039000 (E.D. Pa. 2011)
Because the parties' supply agreement, which lacked a forum-selection clause, "supercede[d] prior oral or written agreements by the parties that relate to its subject matter," the forum-selection clause in the earlier credit agreement between the parties was invalidated.

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