PURCHASE MONEY SECURITY INTERESTS FOR REPETITIVE SALES

INTRODUCTION

During lean and difficult economic times, suppliers of goods often see credit risks increase as buyers' sales take a hit and the bills become harder to pay. In turn, suppliers may be reasonably skeptical of their customers' abilities to adhere to payment schedules. However, if suppliers withhold goods from customers from fear of nonpayment, it only exacerbates the economic woes because the supplier suffers a decrease in revenue and the buyer has less product to sell to its customers. To avoid such a situation and to give the supplier reasonable assurances of payment, the supplier should consider an option under Article 9 of the UCC called a purchase money security interest. Purchase money security interests ("PMSI") are a valuable tool to suppliers who have concerns about their buyers' abilities to pay for goods sold on credit. Our perception, however, is that this tool is often seen as useful for a one-time sale but inefficient where the supplier and buyer engage in frequent transactions. On the contrary, PMSIs can be efficient, useful, and cost effective for suppliers and buyers transacting in repetitive sales environments.

As counsel to suppliers of automobile parts, we often see repetitive sales occurring within the supply chain including original equipment manufacturers ("OEMs") and tier 1, 2, and 3 suppliers. This article uses these transactions as examples of how a PMSI be used effectively for repetitive sales. We discuss how a supplier, making repetitive sales within the context of Tier 1-2 transactions, can use PMSIs as a tool to protect itself in this economic environment. The first part of the article discusses PMSIs generally, as well as the general set-up of Tier 1-2 transactions and how a PMSI fits into that structure. The second part of the article discusses how to efficiently design and structure a purchase money security agreement.

PURCHASE MONEY SECURITY INTERESTS

The Uniform Commercial Code governs PMSIs. A PMSI is an interest in goods securing an obligation for payment for the price of the goods. In the context of an advance, it secures the obligation to repay the advance. UCC 9-103. PMSIs are available for inventory, software, livestock, or other goods. UCC 9-324. This article addresses only PMSIs covering inventory purchases. For the purposes of the UCC, "inventory" is defined as goods for sale, lease, or work in progress. UCC 9-102(48). Therefore, the sale of parts among automobile suppliers and buyers qualifies as inventory.

A perfected PMSI in inventory has priority over a conflicting, usually senior, security interest in the same inventory and entitles the buyer to specific kinds of proceeds. Sometimes the priority given to purchase money security agreements is referred to as a "super priority." A PMSI is used when the supplier wishes to retain its interest in the value of the inventory but a primary lender, usually a bank, has a senior security interest. Typically, the primary lender's interest will be a blanket interest, including after-acquired inventory, equipment, accounts receivable, etc., thereby forcing the supplier into a junior creditor role with respect to the inventory items. A PMSI allows the supplier to trump the primary lender's blanket interest as to the specified goods sold. Therefore, a supplier will want to consider a PMSI when selling to a buyer on credit when the goods will be held by the buyer for a period of time and not immediately converted to finished goods and sold.

There are certain hoops to jump through to perfect the PMSI and leap over normally-superior creditors. *See* 9-324. First, the supplier and buyer must execute a security agreement, which can be part of the sales agreement. Note that the PMSI agreement must relate only to goods transferred after the security agreement. Courts reject security agreements covering prior debts as invalid PMSI agreements. Any inventory transferred to the buyer before the creation of the PMSI agreement will remain unprotected. However, the fact the debtor held one item of inventory before properly creating, filing and giving notice does not subordinate the purchase money creditor regarding inventory acquired in the future. The purchase money agreement will still cover inventory received after the creditor finishes the perfection process.

Second, the PMSI must be perfected. Perfecting the interest is similar to other security interests. The enterprise must file the appropriate financing statements with the appropriate secretary of state or other filing agency, and a perfected interest results.

Third, as spelled out above, in order to receive priority over other lenders, the PMSI must already be perfected at the time the customer receives the goods that comprise the inventory. The supplier 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 other creditor has filed a financing statement. The notice must indicate the PMSI creditor is acquiring or expects to acquire a PMSI on certain items in the buyer's inventory. Further, the notice must describe the covered inventory by item or type. This notice also must be received by the other holder prior to the debtor's receipt of the goods. The notice is valid for five years.

After completing all of the steps to obtain a PMSI, the supplier will have additional remedies if necessary to collect monies owed or repossess the goods sold on credit. With respect to the inventory, the supplier will be first in line for repayment if bankruptcy should occur, and it will have rights to the inventory or some limited proceeds if the inventory has been sold by the buyer.

AUTOMOBILE PARTS MANUFACTURERS AND SUPPLIERS

The automobile parts supply chain operates through a tiered system. At the top of the food chain is the marketplace – car dealerships and the like. Next sits the original equipment manufacturers. These manufacturers assemble parts they manufacture or acquire from other suppliers to create a finished product.

Below the OEMs are Tier 1 suppliers. Tier 1 suppliers are direct suppliers to OEMs – supplying parts that are then assembled to create the finished product. Below Tier 1 suppliers are

Tier 2 & 3 suppliers. Each lower tier supplies customers in the tier above it with materials to create its products, but does not supply OEMs. This type of supply chain is common among industries. Therefore using it as an example of how to use PMSIs should be generally instructive.

Despite the commonalties between supply lines in automotive manufacturing and other industry supply lines, there are a few intricacies in the automotive context bearing on the efficacy of PMSIs that may not be present in other supply lines. Consider the relative economic power between supplier and buyer. Tier 1 suppliers do not possess the bargaining strength to impose a PMSI on an OEM. However, a Tier 2 supplier may be in a position to force the Tier 1 supplier to agree to a PMSI. If the Tier 2 supplier is a "sole source" supplier – that is, the Tier 1 enterprise can only get its goods through a certain Tier 2 supplier, the Tier 2 supplier may possess the leverage to obtain a PMSI. A "sole source" situation is fairly common in the automotive context because OEMs subject Tier 2 goods to testing for quality. Since all goods in the market must be approved, a given item's market may be relatively small, making it difficult for the Tier 1 company to find alternative means of supply. Therefore, a Tier 2 supplier will often be in a position of economic strength to force a Tier 1 buyer to accept the terms of a PMSI.

Setting aside OEMs, we will look at a hypothetical transaction between a tier 1 supplier and a tier 2 supplier. The tier 1 supplier (Company A) assembles rear-view mirrors while the tier 2 supplier (Company B) provides the reflective glass. Since the current economic climate has resulted in depressed car sales, Company B might be concerned the poor revenue flow will trickle up the supply chain. Company B may become suspicious and skeptical of Company A's ability to stay above water and pay their bills. Rather than refrain from selling Company A its mirrors on credit, Company B should look into the possibility of obtaining a PMSI on the goods sold to Company A.

However, Company B and Company A transact business about once every two months, in varying amounts depending on the amount of rearview mirrors Company A sells to the OEMs. If the type of items do not vary extensively from order to order, a PMSI should cover all the glass sold to Company A by Company B and kept in Company A's inventory. Furthermore, one PMSI will apply to all like-inventory sold from Company B to Company A for five years. The language in UCC provision governing PMSIs indicates the notice must be received within five years of the debtor receiving the goods. This means a notice is good for five years. *See* White & Summers, Uniform Commercial Code, Vol. 4, § 33-4 (2009). Therefore, the PMSI is not simply good for one sale, but can cover many transactions over a five year period between a supplier and purchaser.

Nevertheless, there are some limitations on using the same PMSI for more than one transaction. For example, if the supplier changes the type of item, say from reflective glass to a steering wheel, the security interest may not hold up – a new PMSI would be required. However, for many suppliers in the automotive context, consecutive orders are for parts that are similar enough to qualify under the same purchase money security agreement. The next section discusses the degree of similarity required between items from order to order.

Furthermore, obtaining a PMSI makes economic sense because, for relatively low cost, it protects monies or advances from disappearing in bankruptcy. The costs to obtain and maintain a

PMSI would be similar to those associated with obtaining any security interest. Moreover, compared with the money and assets that could be saved, it seems worth the trouble. Otherwise, if the buyer goes into bankruptcy, the supplier may end up waiting in line behind dozens of other unsecured creditors. In the automotive context, orders for parts can be very large and very expensive, and suppliers should not take the risk of losing out on the value of those parts. If suppliers are dealing with the same customers, transacting sales for the same types of items, and the orders are sufficiently large, a PMSI is a protection worth a hard look. In many commercial situations, a PMSI is very efficient and makes good economic sense.

HOW TO PROPERLY STRUCTURE A PURCHASE MONEY SECURITY INTEREST

The steps to obtain and perfect a purchase money security agreement are outlined above. This section discusses how to structure a purchase money agreement in such a way as to ensure its validity and its ability to apply to as many items as possible. If the security interest is termed broadly enough to cover many different kinds of items, then fewer of these interests need be filed to protect a supplier's security interest, saving the supplier time and money.

The ability to utilize one PMSI for many transactions depends in large part on the description included in the notice to the existing creditor, as mandated in UCC 9-324(b)(4). Using Ohio law as an example, the courts have imposed a relatively low bar regarding identification of goods. Ohio interprets the requirements of UCC 9-324 as consistent with other security interest laws requiring descriptions of the collateral. The test of one of "reasonable identification," and a detailed itemization is not required. For example, a reference to "equipment" was enough for one Ohio court, given the circumstances of the case and the definition of "equipment" provided by the Ohio Revised Code. While equipment is dealt with separately from inventory in PMSI statutes, the two are treated similarly enough to compare interpretations of "reasonable description." Descriptions of items in inventory require only details such as specific listing, category, quantity, and the like. Another Ohio court accepted "new and used boats" as illustrative enough to fulfill the requirements of PMSIs. The court specifically rejected the idea that descriptions are insufficient unless they are exact and detailed, in regards to security interests. The purchase money creditor wrote a generic list of products on the PMSI agreement, some of which did not apply to any goods sold to the buyer, but the court found the description satisfactory.

As one can see, the bar is low and a broad description appears to be sufficient. A broad interpretation by courts increases the value and efficiency of a PMSI. Hypothetically, in the automobile context, a single PMSI could be utilized to protect shipments of engines, although there may be substantial differences amongst the engines. The security interest could protect many shipments of tires, although the difference between tires may be substantial. Since the interpretation of "describe" is so broad, fewer PMSIs are required to protect goods sold by a supplier to a buyer on credit.

However, other states may require more detailed description than the Ohio courts require. This article does not discuss other states' laws relating to PMSI descriptions or agreements. Before pursuing a PMSI, a company should examine how the courts in its jurisdiction interpret the provision requiring the creditor to "describe" the goods. A narrower interpretation of the word "describe" may require more PMSI filings, but obtaining the interest may nevertheless be worthwhile for the company, depending on the size of the shipment, the size of the company, and the viability of the buyer.

Despite the relative breadth of the word "describe," companies should consider being as specific as possible under the circumstances, especially in the automotive context. As mentioned above, parts sold from Tier 2 suppliers to Tier 1 suppliers must be approved. Therefore, it is unlikely parts sold from a Tier 2 to a Tier 1 will vary frequently. Practically speaking, usually the exact same item is sold each and every time. When each transaction is identical, there is no reason not to be specific. While courts *permit* vague or broad descriptors, being overly broad may still create problems in dealing with other creditors or the buyer. When the items are identical shipment to shipment, there is no reason to be inexact in the PMSI description.

Parties transacting business in Ohio should also conduct additional research into the matter before attempting to enter into a PMSI. Although this article briefly discusses Ohio law, the paragraphs above are not meant to be legal advice nor should any enterprise rely on this article when structuring a PMSI. Each interest is different and, if done correctly the first time, a PMSI can be procured at relatively little cost in future years, using the original agreement as a model.

CONCLUSION

Depending on one's business model, a PMSI could be a valuable protection against nonpayment or bankruptcy in tough economic times. With proper perfection of a PMSI, sellers can leapfrog senior creditors regarding certain items of inventory. When payment is uncertain, suppliers should take steps to protect themselves. A PMSI provides that protection and allows the supplier to maintain its transactions with the purchaser.

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