By Debra Devassy Babu

Inventory Liens: A Trap for the Unwary Lessor

BECAUSE THE UNIFORM COMMERCIAL CODE (UCC) broadly defines "inventory," an equipment financier may unintentionally finance a debtor's inventory while simultaneously losing its first lien position in the collateral, unless the lender painstakingly follows the UCC's requirements of perfecting a lien in inventory.

Inventory vs. Equipment

Under the UCC, "goods" are defined as "all things that are movable when a security interest attaches" and are classified as consumer goods, equipment, farm products or inventory. "Inventory" means "goods, other than farm products, which (a) are leased by a person as lessor; (b) are held by a person for sale or lease or to be furnished under a contract of service; (c) are furnished by a person under a contract of service; or (d) consist of raw materials, work in process or materials used or consumed in a business." "Equipment" is defined as "goods other than inventory, farm products or consumer goods."

The classifications of goods are mutually exclusive, but goods can fall into different classes of goods at different times, depending on their principal use at a particular time. For example, bulldozers may be "equipment" to a debtor in the excavating business, but "inventory" to a debtor that leases construction equipment to other companies. Generally, goods are equipment if they are fixed assets or have a relatively long period of use. Inventory, by contrast, includes goods leased by the debtor to others; goods held by the debtor for lease in the ordinary course of business; and items that are consumed in a short period of time in producing a product or providing a service.

Thus, in the above example, if a lender finances bulldozers for a debtor that leases construction equipment to third parties, the bulldozers are part of the debtor's inventory and subject to additional perfection requirements under the UCC.

How does a party properly perfect its purchase-money security interest (PMSI) in inventory?

While a PMSI in noninventory goods is usually perfected by filing a financing statement within 20 days of the debtor's receipt of the goods, a lender's perfection of a PMSI in inventory requires different steps. Under the UCC, a perfected PMSI in inventory has priority over a conflicting security interest in the same inventory only if:

- the PMSI is perfected before the debtor receives possession of the inventory;
- the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
- the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and

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- the notification states that the person sending the notification has or expects to acquire a PMSI in inventory of the debtor and describes the inventory. See UCC Section 9-324(b).

The requirements for a PMSI in inventory under Section 9-324 differ in some respects from a PMSI in noninventory goods. First, the lessor is required to file its financing statement prior to the debtor's possession of the collateral. Thus, the typical 20-day grace period between delivery of the goods to the debtor and the filing of the financing statement does not apply.

Second, the lessor must send notice of the future financing to holders of a conflicting security interest in the collateral, which requires the lessor to conduct a UCC search on the debtor prior to funding to identify conflicting interests.

Third, the holder of a conflicting security interest must receive the notification within five years before the debtor receives possession of the collateral. The purchase-money secured party "sends" the notification to the holder of a conflicting interest to the address provided on the filed financing statement, even if that address is or becomes incorrect. The holder of a conflicting interest is deemed to have "received" a notification delivered to that address. Because the timing and receipt of the notification are critical, a lessor should send the notification by certified mail or other method that allows for tracking and maintains records on the holder's receipt of the same.

Finally, the notification must describe the inventory and provide that the party sending the information has or ex-

pects to acquire a PMSI in the inventory. For example, a debtor is in the business of leasing construction equipment to others. A bank has a blanket lien on the debtor's assets, including inventory. The secured party plans to finance bulldozers for the debtor. In order for the secured party to have a PMSI in the bulldozers, it must (1) perfect its security interest in the bulldozers by filing a UCC-1 financing statement prior to tendering possession of the collateral to the debtor and (2) send a notification to the bank within five years before the debtor receives possession of the collateral, with a description of the collateral and an indication that the secured party has or expects to acquire a PMSI in inventory of the debtor. Only then can the secured party achieve lien priority on the bulldozers over the bank.

Does a party have to send notice under Section 9-324(b) each time it finances collateral that may be classified as "inventory," or is one-time notice enough?

The courts are split on whether a security interest in inventory presumptively includes an interest in after-acquired inventory. A minority of jurisdictions holds that a security interest in inventory extends only to inventory in the debtor's possession at the time the security interest attaches; these jurisdictions require that a security agreement expressly include "after-acquired inventory" to broaden a financier's security interest in future inventory. By contrast, a majority of jurisdictions hold that a security interest in inventory presumptively includes after-acquired inventory because of the consistently replenishing nature of inventory. A secured lender should verify the law of the state in which the debtor is located so that it can properly draft the security agreement to include future inventory.

If a purchase-money secured party has not properly perfected its security interest in inventory, is the party's security interest extinguished altogether or subordinate to other liens?

If a purchase-money secured party fails to comply with the provisions of Section 9-324(b), its security interest is not extinguished, but instead is subordinate to priorly filed liens on inventory.

Collateral that a secured lender characterizes as equipment may be deemed inventory and subject to the strict requirements of UCC Section 9-324. Perfecting a security interest in inventory is riddled with unique requirements, but an informed secured party can ensure that its interest is properly perfected and protected. ■

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