Section 3: Perfection and Priority

1. **Perfection:** This is the process by which a creditor puts the world (i.e. other potential secured parties) on notice that it has a security interest in the debtor's collateral.
   a. **Perfection** is accomplished in 1 of 3 ways:
      i. If the creditor ***takes possession of the collateral.***
      ii. If the creditor is makes a loan to the debtor to enable the debtor to purchase ***consumer goods.***
         1. Note: A creditor who loans money to a debtor to enable the debtor to purchase the goods, and who takes a security interest in those goods, is called a ***purchase money security interest holder (PMSI).***
            a. Ex: A debtor takes a loan from a bank to buy equipment for his business, and gives the bank a security interest in that equipment.
            b. Ex: A debtor purchases a refrigerator from a department store on credit, and the department store takes a security interest in the refrigerator.
      iii. If the creditor files a ***financing statement.***
         1. **Financing Statement:** this is a document that is filed in the public records which puts other potential secured parties on notice of the creditor's interest in the collateral. The financing statement must meet the following requirements:
            a. Contain the names and addresses of the debtor and creditor, and a description of the collateral.
            b. Must be filed with the secretary of state in the state where the debtor resides.
               i. Exception: if the collateral is timber, minerals, or fixtures a filing must be made where the real property upon which the above is located (in the case of fixtures, this is called a fixture filing).
   b. **Date of Perfection**
      i. **Rule:** The date upon which perfection is the date on which either (1) the creditor took possession of the collateral, (2) the creditor attaches its interest, in the case of a PMSI in consumer goods only, or (3) the date on which the financing statement is filed.
         1. ***Relation Back Rule***: A creditor may file a financing statement prior to attaching its interest. Once the creditor attaches its interest, it has perfected its interest, with the date of perfection being the date that the financing statement was filed.
2. **Priority**
   a. The rules regarding priority specify the rights of secured parties (as against each other) to look to the debtor's collateral in the event of default by the debtor.
      i. If the debtor defaults on loans given by secured parties, the creditor with 1st priority is entitled to have its loan satisfied in full by looking to the collateral. Once that loan is satisfied the next secured party with priority is entitled to have its loan satisfied in full (assuming the collateral was sold, and the sale yielded more money than needed to satisfy the first creditor's loan).
      ii. **Ex:** Debtor takes out three loans of $50k each, from creditors A, B and C, giving each a security interest in his inventory. Creditor A was first to perfect its security interest, Creditor B was the second to do so, and Creditor C was the last to perfect. Debtor defaults. The order of priority is A, B and then C (*see below for the rule on how to determine priority*). Creditor A holds an auction for Debtor's inventory. The proceeds from the sale yield $75K. Creditor A is entitled to $50K, Creditor B is entitled to $25K, and Creditor C gets nothing. Creditor B and C's only recourse is to go after debtor in a deficiency action for the remaining money owed to them.
   b. **General Rule:** The order of priority is generally determined by the following hierarchy:
      i. **Buyers in the Ordinary Course of Business**
         1. These are persons who buy goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and from a person in the business of selling goods of the kind.
         2. **Rule**: Buyers in the ordinary course take the goods free of any security interests, even if the security interests are perfected and the buyer knows of their existence.
      ii. **Perfected Attached Creditors (PACs)**
         1. These are creditors who have attached and perfected their security interests.

2. **General Rule**: The first creditor to perfect and attach its security interest has priority over everyone except buyers in the ordinary course of business.
   a. **Relation Back Rule**: As mentioned in the previous section, while a creditor must attach its interest at some point, it need not do so prior to filing a financing statement in order to have priority over other later perfected attached creditors.
   b. **Rule for Future Advances:** In many security agreements, the parties agree that the creditor may extend future loans to the debtor which will also be secured by the collateral specified in the security agreement (***future advances***). Assuming the secured party perfects its interest prior to other creditors, in the event that a future advance is made, the secured party will have priority over all other creditors, even if these creditors perfected their interests before the advance was made.
   c. **Rule for Proceeds:** If a debtor sells the collateral and obtains <u>***identifiable proceeds from the sale***</u> (e.g. cash, a check, etc.), the <u>***security interest in the collateral will attach to the proceeds and will be considered perfected***</u>, if the security interest in the original collateral was perfected.
3. **PMSI Rule for *Equipment*:** A PMSI in equipment will have priority over an earlier PAC who has a security interest in the equipment (e.g. that creditor must have an after acquired collateral financing clause in its security agreement with debtor – *see section 2*) if the PMSI **files its financing statement *within 20 days of the debtor taking possession*** of the equipment.
4. **PMSI Rule for *Inventory*:** A PMSI in inventory will have priority over an earlier PAC who has a security interest in the inventory (e.g. that creditor must have an after acquired collateral financing clause in its security agreement with debtor – *see section 2*) if **(1)** the PMSI **files its financing statement *before the debtor takes possession*** of the inventory, **(2)** the PMSI ***sends notice to*** **all other secured parties *before the debtor takes possession*** of the inventory and **(3)** the other secured parties ***receive notice within 5 days of the debtor taking possession*** of the inventory.

iii. Lien Creditors
1. These are creditors that have acquired a lien on the property of the debtor by a court ordered attachment or levy.
2. **Rule:** Lien creditors will only have priority over buyers not in the ordinary course, attached unperfected creditors, and unsecured creditors. As between two lien creditors, the first to attach its interest will have priority over the other.
3. **Exception:** A lien creditor will have priority over an earlier PAC who has made advances to the debtor after the lien creditor attached its interest (only in regard to the advances though, not the original loans or prior advances) unless:
   a. The PAC made the advances within 45 days of the lien creditor attaching its interest; OR
   b. The PAC made the advances without knowledge of the lien creditor's existence.
4. **Note:** The rules for PMSIs in inventory and equipment discussed above with respect to PACs, apply the same way to disputes between PMSIs and LCs.

iv. Buyers *Not* in the Ordinary Course of Business
   a. **Rule:** If a buyer does not meet the definition of being a buyer in the ordinary course of business, the buyer takes the purchased goods subject to the security interests of PACs and lien creditors, but not attached unperfected creditors, or unsecured creditors.
   b. **Exception (Consumer-to-consumer transactions):** If the buyer purchased goods from a seller who used the goods as consumer goods, the buyer will take the goods free from any security interests, even if perfected, if the buyer bought the goods **1)** for value, **2)** without knowledge of the security interest, **3)** for the purpose of using the goods as consumer goods, <u>***and***</u> **4)** before the filing of a financing statement covering the goods.

v. Attached *Un*perfected Creditors
1. These are creditors who have only attached their interests, but have never perfected their interests (i.e. filed a financing statement)

2. **Rule:** Attached unperfected creditors only have priority over unsecured creditors. As between two attached unperfected creditors, the first to attach its interest will have priority over the other.

vi. ***Un*secured Creditors**

1. These are creditors of the debtor who have never secured their loans to the debtor by taking out a security interest in the debtor's property.
2. **Rule:** General unsecured creditors have the least priority of any other party.

3. **Rationale**
   a. As is the rule in most areas of the law, the principle of "first in time, first in right" is the general rule under Article 9. If a creditor is the first to secure and perfect its interest it should have superior rights in the collateral than later creditors. Conversely, if a creditor is first to gain an interest, but fails to take the proper steps to protect that interest, later creditors who take the proper steps to protect their own interests (unaware of earlier creditors) should have greater rights in the collateral.
4. **What Does this Mean?**
   a. If there is a dispute between two creditors who claim a security interest in the debtor's goods, the rules stated above must be applied in order to determine the order of priority between the creditors.
   b. The two disputes that arise the most are (1) PAC v. PMSI, regarding inventory or equipment, and (2) PMSI and/or PAC v. Lien Creditor.
   c. In answering an essay question dealing with priority use the following approach:
      i. (1) What are the types of creditors at issue (e.g. PAC, PMSI, Lien Creditor)?
      ii. (2) What is the collateral at issue (e.g. equipment, inventory, consumer goods)?
      iii. (3) Did the creditors properly attach their security interests? If so, on what dates?
      iv. (4) Did the creditors properly perfect their interests? If so, on what dates?
      v. (5) Compare the dates the above took place, and apply the relevant rules from Article 9 and make a determination as to what the order of priority is (e.g. first priority, second priority, etc.).