

Q6 – July 2016 – Selected Answer 1

1) Bank has a security interest in the washing machines purchased by Appliances. Bank has a purchase money security interest (PMSI) because it allowed Appliances to purchase washing machines for its inventory by naming the washing machines themselves as collateral for the loan. However, the interest may not be perfected. Normally, perfection of a security interest requires attachment as well as an act of perfection. Attachment involves the creditor giving value, an agreement between the creditor and debtor, and the creditor having rights in the collateral. All of these elements must be present for attachment to occur. Here, Bank gave value in that it lent money to Appliances; there was an agreement between Bank and Appliances concerning the collateral; and Bank has rights in the collateral, namely its PMSI.

An act of perfection may occur in a number of ways, including the filing of a financing statement with the secretary of state, which was done in this case. However, there are a number of problems with the financing statement. The name "Joanne's" is misspelled as "Joann's" and the collateral is described as "washing machines" instead of "washing machines." The errors here may invalidate the financing statement, thus rendering Bank's PMSI unperfected, because it would not put other creditors on notice in a record search.

2) Universal has a security interest in the washing machines purchased by Appliances as well. Appliances purchased 10 washing machines from Universal on credit, giving Universal a PMSI in the 10 machines. Universal's interest is perfected. Attachment has occurred because Universal gave value, there is an agreement between Universal and Appliances, and Universal has rights in the collateral. In addition to attachment, Universal properly filed a financing statement, a valid act of perfection. Universal did not have notice of Bank's PMSI due to the errors in Bank's financing statement. Universal's financing statement filed with the secretary of state therefore gives it a perfected PMSI in the washing machines.

3) There are two PMSIs in the washing machines, and Universal has priority. Normally, security interests take priority according to the principal of first in time, first in right. However, as between two PMSIs in the same collateral, a perfected interest has priority over an unperfected interest even if it was not the first in time. Universal's interest was perfected because it attached the collateral and filed a proper financing statement with the secretary of state. Bank's interest was unperfected because even though it attached and filed a financing statement before Universal, Bank's financing statement had a number of errors that invalidated it because it failed to put subsequent creditors on notice. Therefore, Universal has priority over Bank with regard to the washing machines.

Q6 – July 2016 – Selected Answer 2

Bank

Bank has a valid security interest in the washing machines. To have a valid security interest, the creditor must have his interest attach to the debtor's collateral, which requires three things: the debtor must give value, there must be a proper underlying agreement that the security interest attach, i.e., a security agreement, and the debtor must have rights in the collateral. All three are present. The debtor has given value, the machines. There is a valid security agreement in place. To be valid, the security agreement must clearly evidence it was the intent of the parties that a security interest attach and the collateral must be identifiable. The collateral does not need to be identified in detail specificity, it just must reasonably identify the collateral, but it cannot be supergeneric, such as all of the debtor's assets. These requirements have been met. The security agreement gave bank a security interest and the collateral was appropriately named as washing machines. Finally, the debtor had rights in the collateral, i.e., when he bought them he had rights starting June 10, they weren't somebody else's and that is when the agreement kicked in. Therefore, Bank has a valid security agreement and it has attached as between Bank and Appliances.

Bank is arguably not perfected. While attachment of a security interest creates in the creditor a superior interest over the debtor, the creditor needs to perfect that interest to be protected against other creditors. Perfection can happen in a number of ways. First, this type of loan would qualify as a Purchase Money Security Interest (PMSI), i.e., a loan that enables the debtor to go out and buy a particular piece of collateral. PMSIs in consumer goods automatically have permanent perfection. While a washing machine can qualify as a consumer good (a good used for person, family, or household use), the classification of a good is always determined from the view point of the debtor. Here, Appliance is engaged in the business of selling washing machines in a retail store. Because it is not being used for consumer purposes, it is not automatically perfected permanently. BUT, PMSIs do enjoy temporary perfection for 20 days from the time the debtor takes possession.

A creditor can also be perfected via filing. Filing gives notice to the world of the creditor's security interest. Filing is done by filing a financing statement with the Texas Secretary of state, giving the names and address for both the debtor and the creditor, attaching the agreement the debtor and creditor have, and describing the collateral therein. Here, Bank has attempted to perfect by filing. Perfection by filing can be done before the debtor receives the goods. A financing statement is effective for 5 years, so it is no problem that Appliances receives the goods a week and a half later as perfection will relate back. But, there is an issue with Bank's financing statement as it has misspelled the debtor and the collateral because of the spelling mistake. Generally, minor errors that are not seriously misleading are fine. BUT when they are seriously misleading, i.e., when someone searching for the debtor cannot find the financing statement under the correct name, then the financing statement will not protect the creditor against other creditors. The misspelled name of the collateral (washing instead of washing) is probably not seriously misleading because someone who saw that and knew Appliance was in the business of selling washing machines could probably figure it out or at least be on inquiry notice. The main problem is with the misspelling of the debtor's name. While only a one letter omission may seem harmless, it is apparent from the facts that when a subsequent purchaser went to look for Appliance under the correct name, Bank's financing statement didn't show up. Thus, the name is seriously misleading and won't protect Bank from other creditors. But they are still given the 20 day window in which to perfect (which expired June 30).

Universal

Universal has a valid security interest in the washing machines. The same three elements noted above for attachment also apply here. The facts stipulate that Universal has a security agreement with Appliance. Assuming all of the requisites are met (in writing, adequate identification in the collateral), it appears Appliance also gave value and had rights in the collateral. Thus, Universal's agreement has attached and is valid as against the debtor here. Universal is also properly perfected. Universal has retained a PMSI, i.e., the sold goods on credit and retain a security interest in the collateral they sold. As mentioned above, they are automatically perfected for 20 days because this is a security interest in inventory (not a consumer good for permanent automatic perfection). But, Universal has perfected via filing too. They have filed a financing statement with the Texas Secretary of State, which is the appropriate office for financing statement filings (unless it's a fixture filing, then file in county where real estate sits). So long as they comply with the requisite financing statement formalities (name and address of creditor and debtor that is not seriously misleading, security agreement, collateral description), then they are properly perfected for the next five years (will need to file a continuation financing statement within 6 months of expiration to continue perfection).

Bank v. Universal

Universal has priority over Bank in the washing machines. First, as between a perfected secured creditor and an unperfected secured creditor, the perfected secured creditor will always win. Here, Bank was not properly perfected because their financing statement was seriously misleading. Universal searched for Appliances under the correct name and therefore is seriously misled. Therefore Universal wins. Even if it is assumed the Bank is perfected (if the suit takes place before June 20 when Bank's temporary perfection for PMSI runs out), Bank would still lose. When determining priority, perfection is deemed to occur at the time of either filing or perfection (which can't happen until attachment which requires the debtor to have rights in the collateral, i.e., once Appliance actually bought the machines). Thus it would appear that Universal and Bank were perfected as soon as Appliance took the machines. But, when it comes down to priority between a PMSI creditor that enabled the debtor to buy the goods against a PMSI creditor that actually sold the goods, the PMSI creditor that actually sold the goods has priority. Thus, regardless of the court thinks of Bank's financing statement, Universal is still going to win.

1. (a) Bank does have a security interest in the washing machines purchased by Appliances

Generally, in order for a party to acquire a security interest in collateral, it must attach to the collateral. For attachment to occur, the party must give value, to a debtor who has rights in the collateral, and authenticate a security agreement that describes the collateral. The description of the collateral must clearly indicate the collateral and may not be overly broad or unambiguous. To qualify as a purchase money security interest holder a party must give value for the party to purchase the collateral and the interest must be perfected. Here, Bank gave value for Appliances to purchase washing machines and Appliances signed or authenticated the security agreement. The security agreement described the washing machines, which are inventory of Appliances. Because the requirements for attachment have been made, Bank has a "lender" purchase money security interest in the inventory of Appliances.

(b) Bank's security interest is not a perfected security interest.

Generally, for a security interest to be perfected, the interest holder must 1) file a financing statement with the Secretary of State, 2) possess the collateral described, or 3) have control over the collateral. The purpose of the financing statement is to put other interest holders on notice. Therefore, the name of the debtor is important, the description of the collateral must be present and the address of the interest holder and debtor must be present with indication of the security agreement. Here, Bank attempted to perfect its security interest by filing a financing statement with the Secretary of State. Bank attempted to file its financing statement on June 1, however, when Bank filed its financing statement had two serious errors that affected the perfection of their security interest.

First, Bank's financing statement indicated "washing machines" instead of washing machines. Generally, the description of the collateral in a financing statement can be more broadly stated than in the security agreement. Second, Bank mistakenly spelled Joann's Appliances instead of Joanne's Appliances. With respect to errors within financing statements, if the error is not seriously misleading then the interest can still be perfected. The standard for determining if an error is seriously misleading is if a search in the Secretary of States security system would pick up the name of the debtor. Here, a search by Universal did not pick up Appliance's name due to the misspelling. Therefore, the error was seriously misleading. Bank must file an amendment to correct the spelling of the name and the error in the description of the collateral to perfect its security interest.

2. (a) Universal does have a security interest in the washing machines purchased by Appliances

Universal gave value for the purchase of 10 washing machines through a line of credit at Universal. Universal potentially has a seller PMSI in inventory which prevails over all prior if properly perfected. The money must be used to purchase the goods in order to qualify as a seller PMSI. Universal's security interest attached when it obtained a security interest that is signed by the debtor containing a description of the collateral.

(b) Universal's security interest is a perfected security interest.

To perfect a purchase money security interest, there are certain statutory requirements to ensure priority. A PMSI holder in inventory must notify any prior interest holders in the same collateral before delivering to the debtor. Universal searched for prior interest holders and due to Appliances error, it had no notice of prior financing statements and interest holders. It then filed its financing statement with the secretary of state. Accordingly, Universal has a PMSI in the 10 washing machines that were purchased on June 10.

3. There is more than one security interest in the washing machines purchased by Appliances. Appliances used both the borrowed money from bank and the line of credit from Universal to purchase the washing machines from universal. Both Bank and Universal have purchase money security interests in the inventory of Appliances. However, priority is determined by the first to perfect. The first party to perfect is the first to file. Here, **Universal has priority with respect to their interest in the washing machines purchased by Appliances.** A purchase money security interest in inventory has priority over all other interest holders in the same when it is perfected by filing and proper notice has been given. As between two perfected security interest holders, the first to file has priority. Because Bank needs to amend its financing statement it will not have priority over Universal's interest. It should refile and amend to protect its interest. Assuming both interests had been perfected, a seller PMSI has priority over a lender PMSI and the facts here indicated that Bank was a lender PMSI because it loaned the money to Appliances to purchase the washing machines and Universal was a seller PMSI because the washing machines were purchased from Universal.