Welcome to this podcast on Purchase Money Security Interests Part II brought to you by CALI. I am Professor Scott J. Burnham.

The topic of this podcast is to identify when a purchase money security interest (“PMSI” or PIM-zee) has been created and to identify fact patterns that frequently appear on law school and bar examinations where it is significant that a security interest is a PMSI.

A PMSI is simply a specific type of security interest. As with any security interest, there must first be attachment under the rules of § 9-203. The creditor must give value, the debtor must have rights in the collateral, and most commonly there must be a security agreement that is authenticated by the debtor that grants the creditor a security interest in specified collateral. On top of that, according to § 9-103, to make it a PMSI, either a seller takes a security interest in the goods it sold to the debtor or a lender takes a security interest in goods that are purchased with the money it loaned.

Let’s look at an example. I need a new refrigerator and go to Megamart, which agrees to sell me a refrigerator on credit, so long as I grant Megamart a security interest in the refrigerator. Megamart as the seller of the refrigerator would have a PMSI in the refrigerator. By the way, most credit card purchases are not secured transactions. However, this is not always the case. You are free to agree with a credit card issuer that you grant the issuer a security interest in goods you purchase with that credit card. The receipt is likely to state that the goods are purchased pursuant to a security agreement and when you sign the receipt you have authenticated the agreement. Alternatively, if I had gone to First Bank and took out a loan and used the money to purchase the refrigerator, First Bank would have a PMSI because it loaned me the money that enabled me to acquire rights in the collateral.

You may wonder how we know whether money loaned was used to acquire the collateral. This is a tracing problem. For example, if First Bank loaned me money, and I put the money in my bank account, and then withdrew the money from my bank account to pay Megamart, I did not necessarily pay Megamart with the money I got from First Bank. To avoid this problem, First Bank might give me a two-party check, payable to me and Megamart. I would then have to indorse it and give it to Megamart, which would ensure First Bank that the money was used to acquire the collateral from Megamart.

Once a security interest has attached, it is effective against the debtor, but the secured party may wish to perfect it in order to have priority over third parties such as other secured creditors. One of the most significant aspects of a PMSI is that a PMSI in consumer goods is automatically perfected on attachment under § 9-309. The creditor does not have to file or use any other method to give notice of its security interest.

It is important to remember that while there can be a PMSI in any type of goods, only the PMSI in consumer goods is automatically perfected. According to § 9-102(a)(23), consumer goods are “goods that are used or bought for use primarily for personal, family, or household purposes.” The policy behind this rule is probably that it is not cost-effective for a creditor to file a financing statement in a consumer goods transaction, most of which are for relatively small amounts of money. However, there is no dollar limit on the automatic perfection rule. If I purchase a million-dollar painting for my home from a gallery on credit and grant the gallery a security interest in the painting, that security interest is a PMSI in consumer goods and is automatically perfected.

There is one important exception. If there is a certificate of title statute providing for the goods to be titled, then automatic perfection does not apply. So if an auto dealer sells me a car on credit and takes a security interest in the car, the PMSI is not automatically perfected. To perfect its security interest, the car dealer will have to comply with the certificate of title statute, which usually requires that the security interest be noted on the title.

A second fact situation in which a PMSI is significant is the superpriority rules of § 9-324. A secured party with a PMSI in goods such as inventory and equipment can prevail over an earlier filed secured party who does not have a PMSI if it jumps through the hoops that are outlined in that section. That section is discussed in detail in the CALI podcast Purchase Money Security Interests Part I.

Another PMSI fact situation arises under § 9-317. This section provides that a lien creditor – a judgment creditor who has had the sheriff levy on property – takes priority over a secured party that has not perfected its security interest. However, if that security interest is a PMSI, then the secured party has 20 days from the date of delivery to perfect its security interest and it will be effective retroactively to the time of attachment. For example, on January 15, a creditor obtains a judgment against D Inc. On February 2, S Inc. sells D. Inc. a computer and takes a security interest in the computer, which is delivered on that day. On February 5, the lien creditor has the sheriff levy on the computer. On February 7, S. Inc. properly files a financing statement. S Inc. has priority over the lien creditor in the computer. The general rule is that the lien creditor has priority over an unperfected security interest, so if the security interest was not a PMSI, the lien creditor would have priority. But the exception for a PMSI gives the creditor 20 days from delivery to perfect. Here, S Inc. timely perfected its PMSI, so it has priority over the lien creditor.

By the way, for those of you with some knowledge of the significance of security interests in bankruptcy, Bankruptcy Code § 544(a), often referred to as “the strong arm clause,” provides that the bankruptcy trustee has the status of a hypothetical judicial lien creditor at the time of the filing of the bankruptcy petition. That means that the trustee, like the lien creditor, has priority over unperfected security interests. In other words, an unperfected security interest is not effective once the debtor declares bankruptcy. However, the exception for a PMSI applies in bankruptcy as well, and as an exception to the automatic stay on actions by creditors, the secured party with a PMSI may effectively file within 20 days of delivery even if the filing of the financing statement comes after the filing of the bankruptcy petition.

Section 9-320(b) contains what I call the “yard sale” rule. It provides that a buyer who buys consumer goods to use as consumer goods without knowledge of a security interest, takes free of the security interest, even if the security interest is perfected, so long as the security interest is not perfected by filing. That’s a lot of elements. For an example, let’s go back to the refrigerator I bought from Megamart. It is consumer goods in my hands. I agree to sell it to you for use in your home, so it is consumer goods in your hands. I don’t tell you there is a security interest in it, so you don’t have actual knowledge of the security interest. Because Megamart relied on automatic perfection and did not file, you don’t have constructive knowledge of the security interest either. Therefore, you take free of the security interest. However, if Megamart had been cautious and had filed rather than relying on automatic perfection, then you would take subject to the security interest. That is to say, Megamart could foreclose on it even though you own it. Here’s a little review of sales law. What would you do if that happened? You would have a claim against me under § 2-312 for breach of the warranty of title, because I gave you a warranty that the goods were delivered free of any security interest that you did not have actual knowledge of.

Finally, with respect to fixtures, the priority rules for fixtures in § 9-334 provide that the interest of an encumbrancer or owner of the real property has priority over a later arising security interest in fixtures. However, if the security interest is a PMSI, then the PMSI has priority as long as it is perfected before the goods became fixtures or within 20 days thereafter. For example, a building is subject to a mortgage held by First Bank. A seller sells the owner of the building a new furnace on credit and installs it in the building. Since the seller had a PMSI in the furnace, as long as the seller makes a fixture filing within 20 days after installation, the seller will have priority in the furnace over the bank. Note that this makes sense because the bank is not losing anything. If the owner defaults, the seller can foreclose only on the furnace that it sold to the owner.

At this point, you should be able to identify and describe what a PMSI is, and you should be able to identify its significance in the following fact situations: automatic perfection of a security interest in consumer goods, superpriority in equipment and inventory, priority contest with a judicial lien creditor or bankruptcy trustee, priority contest with a buyer when there is a “yard sale” purchase, and priority contest with an owner or encumbrancer as to fixtures.

I hope you’ve enjoyed this podcast on Purchase Money Security Interests Part II.

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