

Financial Services Alert: A Cautionary Tale Regarding the Strict Notice Requirements for Purchase Money Security Interests

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The notice requirements for a purchase money security interest (PMSI) can be tricky, and the party relying on a PMSI must carefully follow the rules or risk losing a priority security interest. An April 2019 decision^[1] by the U.S. Bankruptcy Court for the District of Delaware is illustrative. A summary of the case and key takeaways and best practices follow.

Sports Dimension Inc. ("Sports Dimension"), a sports apparel manufacturer, sent notice of its security interest to Bank of America (BoA). But BoA was the predecessor administrative agent and its Uniform Commercial Code (UCC) financing statement had been assigned to Wilmington Savings Fund Society ("Wilmington"). Wilmington, as the successor administrative agent, had filed a UCC-3 amendment showing the assignment and its address. One issue in the litigation was which party had a priority interest in inventory sold and the resulting proceeds. Because Sports Dimension failed to send notice to Wilmington, the Court found Sports Dimension failed to meet the notice requirements for a PMSI and ordered Sports Dimension to disgorge all proceeds of the inventory in dispute.

In 2006, The Sports Authority Holdings, Inc. and its affiliates (collectively, "Debtors"), national retailers of sporting goods and active apparel, obtained a term loan. BoA was the administrative agent for the lenders that provided the term loan, which was secured by, in part, a lien in Debtors' inventory and the proceeds thereof. In 2015, Wilmington succeeded BoA as the administrative agent, and in 2016, Debtors filed for bankruptcy. At the time of the filing, Debtors owed approximately \$277 million on the loan.

Sports Dimension began selling to the Debtors in the 1990s, but did not file a UCC financing statement to cover the goods until 2016, approximately one month prior to Debtors' bankruptcy filing. Wilmington had filed its UCC-3 amendment first. Wilmington argued Sports Dimension failed to follow the PMSI rules under the UCC, and therefore, Wilmington's security interest had priority.

Under UCC 9-322(a), conflicting perfected security interests rank according to time of filing UCC financing statements. UCC 9-324(b) provides an exception, however, for a party that obtains a PMSI in inventory if: (1) the PMSI is perfected when the debtor receives possession of the inventory; (2) the purchase-money



secured party sends an authenticated notification to the holder of the conflicting security interest; (3) the holder of the conflicting security interest receives notification within five years before the debtor receives possession of the inventory; and (4) the notification states that the sender has or expects to acquire a PMSI in inventory of the debtor and describes the inventory.

Ruling for Wilmington, the Court found no support for Sports Dimension's argument that proper notice to BoA constituted proper notice to Wilmington and no evidence that BoA forwarded the notice to Wilmington. The Court held, therefore, that Sports Dimension failed to satisfy the requirements for a PMSI, and Wilmington had priority.

Here are some key takeaways and best practices:

- File a UCC financing statement as soon as possible to avoid having to rely on the PMSI exception.
- After filing the UCC financing statement, if seeking a PMSI, wait a short period of time (one day should be sufficient), and then run a UCC search on the debtor's name to determine all the secured parties to which to send notice. The waiting period is to guard against the search missing interim filings filed after the search but before the time of filing the UCC financing statement. Do not wait too long, though, because holders of conflicting security interests must receive notice before the debtor receives the collateral.
- Send a PMSI notice to holders of conflicting security interests whose financing statements were filed before the PMSI financing statement. Secured parties who filed later do not need a PMSI notice; the first-to-file rule provides priority to the PMSI financing statement. But if there is any doubt about whether to send a notice, send it. Postage is cheaper than a priority fight. And if there has been a UCC-3 assignment, send notice to the assignor and the assignee. Do not assume sending notice to one is sufficient or that the assignor no longer requires notice. Sports Dimension lost because it sent notice to the assignor BoA but not the assignee Wilmington.

For additional information or questions regarding PMSIs, please contact a member of the Financial Services team at Gray Plant Mooty.



[1] *In re: Tsawd Holdings, Inc.* (Bankr. D. Del. April 12, 2019, Case No. 16-10527).