**Priority: Sellers v. Secured Parties**

Welcome to this podcast on Priority: Sellers v. Secured Parties brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is which party will prevail in a competition for collateral as between sellers and the creditor with a security interest in the debtor’s assets. While secured parties might expect to prevail with respect to their collateral most of the time, sellers of goods to a debtor who have not been paid for the goods also have expectations. This podcast will examine the rules that come into play in three situations: (i) when a secured creditor has used an after-acquired property clause, or otherwise has a floating lien on inventory, including the retention of title rules of U.C.C. §§ 1-201(b)(35) and 2-401; (ii) purchase money security interests under § 9-324; and (iii) the seller’s right of reclamation arising under U.C.C. § 2-702. These rules are commonly tested on law school and bar examinations so pay close attention.

Let’s look at a hypothetical.

Kitchenware borrows $200,000 from Bank and signs a security agreement granting Bank a security interest in “all inventory that Kitchenware now owns or that it manufactures or acquires in the future.” Bank files an effective financing statement reflecting this security interest. Kitchenware contracts with Copperco to buy two separate deliveries of copper sheets for its cookware, with one-half of the contract price due after the first delivery and the balance due after the second delivery. Copperco delivers the first delivery of copper sheets to Kitchenware. Copperco loads the second truck for delivery to Kitchenware, but being unpaid, Copperco does not deliver the second delivery of copper sheets.

Let’s look at the basic rules regarding floating liens on inventory. In our case, if Kitchenware defaults, what are the rights of Copperco and the bank? You may recall that even if a seller were to expressly state that title did not pass until it was paid for the goods, title would pass nevertheless and all the seller would have is a security interest under the rules of U.C.C. §§ 1-201(b)(35) and 2-401. Note that in the ordinary case the security interest would be unperfected. So, a retention of title does not adequately protect the seller. The seller will need to do more than recite a retention of title.

So, when Copperco sells the sheets to Kitchenware, when does the bank’s security interest attach? The standard rules on attachment of a security interest apply, granting a secured creditor a security interest in collateral so long as the requirements of value, rights in the collateral and authenticated security agreement or other validating device are satisfied under § 9-203. A debtor does not have to own collateral in order for the debtor to have rights to the collateral and the security interest of the creditor to attach under § 9-203(b). Basically, rights to the collateral does not necessarily mean full ownership or even that the debtor has paid for the goods.

The rules of Article 2 shed light on when a buyer has rights to goods. Under Article 2, a buyer of goods can have rights to the goods upon *identification* to the contract. In our situation, it would seem to occur at least when the seller places the copper sheets for Copperco on the truck. It would seem that the security interest of Bank could attach at that time, even though the goods have not yet been delivered to the buyer. But that does not resolve our issue. While Article 9 gives effect to a security interest in favor of the lender at this earlier point in time, an interest in favor of a *seller* arising under Article 2 will have priority until the debtor obtains possession of the goods under the rule of § 9-110. So in our situation, the seller, Copperco, will have the superior interest in the copper sheets that are still on the truck, because it has not yet delivered the goods to the buyer. Once it has been delivered, however, the security interest of the Bank attaches even if the seller has not been paid.

But there is an out for the seller, which requires us to look at the rules for purchase money security interests. In particular, what happens when the seller of goods has not been paid, but the goods are in the possession of the buyer? Well, a seller that wants priority will have to claim a purchase money security interest under the rules of Article 9 to obtain priority in the goods they sell. In our hypothetical, the copper sheets as raw materials would be considered inventory. The seller would have to comply with the rules for inventory purchase money priority of § 9-324, which requires not only that the seller perfect a security interest before the debtor receives possession of the inventory, but also that the seller send an authenticated notification of the seller’s security interest to the holder of a conflicting security interest within five years before the debtor receives possession of the inventory. In our hypothetical, Copperco has not claimed a purchase money security interest or complied with the rules of §9-324 in order to prevail over Bank. As such, the Bank will have the superior interest in the copper sheets that have already been delivered to the debtor, Kitchenware, because Copperco has not properly claimed a superior purchase money security interest.

While it is not raised in our problem, not all purchase money security interests concern inventory. A secured party might have a floating lien on equipment, for instance. The purchase money security interest rules of § 9-324 are different if the collateral is not inventory. The rule states that the perfected purchase money security interest other than inventory has priority over the conflicting security interest in the same goods, so long as it is perfected when the debtor receives possession of the collateral or within 20 days thereafter. So, presume that Copperco also sold Kitchenware a pressing machine and Bank had a security interest in equipment, including after acquired equipment. So long as Copperco perfected a security interest before Kitchenware got possession of the machine or within 20 days thereafter, Copperco would have priority over a prior perfected security interest of Bank – but only in the equipment it sold to Kitchenware. These § 9-324 priorities in collateral are often referred to as a “superpriority.”

Before we conclude, let’s look at the seller’s right of reclamation under Article 2. The right of reclamation under § 2-702 sometimes protects a seller who remains unpaid for goods delivered to a buyer. Article 2 gives the seller a right to reclaim goods that a buyer receives while insolvent, but must make a demand to the buyer within 10 days of the buyer’s receipt of the goods. This is a very small window in which a seller can act, so this rule does not come up too often. Furthermore, the seller’s right of reclamation is subordinate to the right of a creditor with a perfected security interest in the goods, so unless the creditor is fully secured, the seller is going to lose out.

At this point, you should be able to identify and describe when and how a seller will have to comply with Article 9 in order to protect its interest in goods delivered to a buyer that has not yet paid for the goods. You should also be able to apply the rules related to purchase money security interests and determine when a seller might have a right of reclamation under Article 2.

I hope you’ve enjoyed this podcast on Priority: Sellers v. Secured Parties.

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