

5

Priority of Security Interests

- I. In General §5.1
- II. Temporal Priority Rules (First to File or Perfect)
 - A. In General §5.2
 - B. Special Rules for Proceeds
 - 1. Proceeds of Filing Collateral §5.3
 - 2. Proceeds of Nonfiling Collateral
 - a. Definitions of *Filing* and *Nonfiling* Collateral §5.4
 - b. Baseline Rule §5.5
 - c. Exception to the Baseline Rule §5.6
 - C. Statutory Exceptions to Rules §5.7
- III. Rights of Lien Creditors and Certain Transferees
 - A. Lien Creditors §5.8
 - B. Transferees of Tangible and Intangible Collateral §5.9
 - C. Purchase-Money Security Interests §5.10
- IV. Rights of Third-Party Creditors, Buyers, Lessees, Licensees, and Reclaiming Sellers
 - A. Rights of Creditors in Sold Collateral and Consigned Goods
 - 1. Sold Collateral §5.11
 - 2. Consigned Goods §5.12
 - B. Rights of Buyers of Goods in the Ordinary Course of Business
 - 1. In General §5.13
 - 2. Consumer Goods §5.14
 - 3. Goods in the Possession of a Secured Party §5.15
 - 4. Farm Products §5.16
 - C. Licensees of General Intangibles and Lessees of Goods in the Ordinary Course of Business §5.17
 - D. Rights of Reclaiming Sellers §5.18
- V. Priority of Future Advances
 - A. In General §5.19
 - B. Competing Security Interests §5.20
 - C. Competing Lien Creditors §5.21
 - D. Competing Buyers and Lessees §5.22
- VI. Nontemporal Priorities
 - A. In General §5.23
 - B. Purchase-Money Security Interests
 - 1. In General §5.24

- 2. PMSI in Inventory §5.25
 - 3. PMSI in Livestock §5.26
 - 4. PMSI in Software §5.27
 - 5. Exception to All PMSI Priority Rules §5.28
 - C. Deposit Accounts §5.29
 - D. Investment Property
 - 1. The Control Rule §5.30
 - 2. Conflicting Security Interests Perfected by Control §5.31
 - 3. Conflicting Security Interests in Certificated Securities §5.32
 - 4. Residual Rule of Priority §5.33
 - E. Letter-of-Credit Rights §5.34
 - F. Chattel Paper and Instruments
 - 1. In General §5.35
 - 2. Chattel Paper
 - a. Purchaser Versus Inventory Financier §5.36
 - b. Purchaser Versus Other Secured Party §5.37
 - 3. Instruments §5.38
 - VII. Miscellaneous Priorities
 - A. The “Double Debtor” Problem §5.39
 - B. Security Interests Created by New Debtors §5.40
 - C. Transferees of Funds §5.41
 - D. Liens Arising by Operation of Law §5.42
 - E. Security Interests in Fixtures and Crops
 - 1. In General §5.43
 - 2. Residual Rule §5.44
 - 3. Exceptions: Purchase-Money Security Interests in Fixtures §5.45
 - 4. Exceptions: Perfected Security Interests in Fixtures §5.46
 - 5. Exception: Consent, Disclaimer, or Right to Remove Fixtures §5.47
 - 6. Exception: Construction Mortgages §5.48
 - 7. Crops §5.49
 - F. Security Interests in Accessions §5.50
 - G. Security Interests in Commingled Goods §5.51
 - H. Security Interests in Goods Subject to Certificates of Title
 - 1. In General §5.52
 - 2. Interstate Motor Vehicle Transactions §5.53
 - I. Subordination of Security Interests §5.54
 - J. Bank’s Setoff and Recoupment Rights Against Deposit Accounts
 - 1. In General §5.55
 - 2. Priority of Setoff and Recoupment Rights §5.56
- Form
- 5.1 Deposit Account Control Agreement

I. In General

§5.1 Business lawyers must be keenly aware of the priority rules contained in Article 9 in order to protect their clients' rights and interests. Because a security interest is enforceable between the secured party and the debtor without regard to perfection, as long as the security interest is attached to collateral, there can be no meaningful priority contest between the secured party and the debtor. Priority issues may arise, however, among competing secured parties, between secured parties and tax creditors or other purchasers from the debtor, or between secured parties and the debtor's bankruptcy trustee. The possibilities for controversy are numerous, but Article 9's comprehensive priority provisions generally provide a ready answer.

One of the most familiar scenarios is when the bankruptcy trustee of the debtor seeks to avoid an unperfected security interest under 11 USC 544(a) of the Bankruptcy Code and realize the value of the collateral for the benefit of the debtor's unsecured creditors. Another common example is a contest between two secured creditors for the same collateral. The determination of which security interest has priority will often decide who will be paid and who will not. This issue often arises when one secured creditor forecloses and sells collateral at a public or private sale or when collateral is sold by a bankruptcy trustee under 11 USC 363, with all security interests attaching to the sale proceeds in the same priority that those interests had in the original collateral.

To understand the priority rules, it may be helpful to note that Article 9 establishes *temporal* priority rules—rules premised on the timing of events—and *nontemporal* priority rules—premised on overarching policies other than the race of diligence among creditors.

II. Temporal Priority Rules (First to File or Perfect)

A. In General

§5.2 MCL 440.9322 states the general rule that the first secured party to file a financing statement covering the collateral or to otherwise perfect will have priority over competing security interests. This is often referred to as the “temporal” priority rule, and it reflects the time-honored tradition of rewarding the most diligent creditor in the race to the collateral. The exceptions to this general rule, discussed below, relate to security interests in deposit accounts, investment property, letter-of-credit rights, chattel paper, instruments, fixtures, and purchase-money security interests (PMSI). UCC §9-322 comment 2. Other exceptions are security interests arising under Articles 2, 2A, 4, and 5. *Id.* The rules of priority governing these various exceptions to the general rule are often referred to as “nontemporal” priority rules because priorities do not depend on which secured party was the first to file or perfect but on other factors generally reflecting different policy choices.

MCL 440.9322(1) sets forth three general rules of temporal priority. These rules are based on the common-law concept “of a race of diligence among creditors.” UCC §9-322 comment 3. The first rule is as follows: unless otherwise provided in MCL 440.9322(1), the first secured party or agricultural lienor to file a

financing statement or otherwise perfect its interest or lien in the collateral will have priority over holders of security interests or liens that are subsequently acquired or perfected. MCL 440.9322(1)(a). The time of priority is established on the earlier of filing or perfection, as long as “there is no period thereafter when there is neither filing nor perfection.” *Id.*

UCC §9-322 comment 4 explains the operation of this first general rule of temporal priority:

When there is more than one perfected security interest, the security interests rank according to priority in time of filing or perfection. “Filing,” of course, refers to the filing of an effective financing statement. “Perfection” refers to the acquisition of a perfected security interest, i.e., one that has attached and as to which any required perfection step has been taken.

...

The rule of subsection [(1)(a)], affording priority to the first to file or perfect, applies to security interests that are perfected by any method including temporarily (Section 9-312) or upon attachment (Section 9-309), even though there may be no notice to creditors or subsequent purchasers and notwithstanding any common-law rule to the contrary.

The second rule of temporal priority is also the most obvious one. Unless otherwise provided in MCL 440.9322(1), a perfected security interest or agricultural lien will have priority over conflicting unperfected security interests and agricultural liens. MCL 440.9322(1)(b). The third general rule is set forth in MCL 440.9322(1)(c): the first unperfected security interest or agricultural lien “to attach or become effective” will have priority over conflicting security interests and agricultural liens that are also unperfected. As explained in UCC §9-322 comment 11, this last rule

may be of merely theoretical interest, inasmuch as it is hard to imagine a situation where the case would come into litigation without either secured party’s having perfected its security interest. If neither security interest had been perfected at the time of the filing of a petition in bankruptcy, ordinarily neither would be good against the trustee in bankruptcy under the Bankruptcy Code.

Creditors dealing with a debtor who promptly files for protection under the Bankruptcy Code may find themselves in this predicament if they fail to file a financing statement before the bankruptcy petition date. This is so because the automatic stay that takes effect on filing a bankruptcy petition generally bars creditors from taking steps to perfect prepetition security interests. *See* 11 USC 362(a). *But see* 11 USC 362(b)(3), 546.

B. Special Rules for Proceeds

1. Proceeds of Filing Collateral

§5.3 MCL 440.9322(2)(a) contains the general rule of priority of security interests in proceeds of the original collateral. With respect to security interests that are perfected by the filing of an effective financing statement, the time of filing or perfection of an interest in the original collateral “is also the time

of filing or perfection [of] a security interest in proceeds.” The operation of this rule is illustrated by UCC §9-322 comment 6, example 5:

On April 1, Debtor authenticates a security agreement granting to A a security interest in all Debtor’s existing and after-acquired inventory. The same day, A files a financing statement covering inventory. On May 1, Debtor authenticates a security agreement granting B a security interest in all Debtor’s existing and future accounts. On June 1, Debtor sells inventory to a customer on 30-day unsecured credit. When Debtor acquires the account, B’s security interest attaches to it and is perfected by B’s financing statement. At the very same time, A’s security interest attaches to the account as proceeds of the inventory and is automatically perfected. See Section 9-315. Under subsection (b) of this section, for purposes of determining A’s priority in the account, the time of filing as to the original collateral (April 1, as to inventory) is also the time of filing as to proceeds (account). Accordingly, A’s security interest in the account has priority over B’s. Of course, had B filed its financing statement before A filed (e.g., on March 1), then B would have priority in the accounts.

2. Proceeds of Nonfiling Collateral

a. Definitions of *Filing* and *Nonfiling Collateral*

§5.4 MCL 440.9322(3), (4), and (5) establish special rules for proceeds “in situations where the temporal (first-in-time) rules of subsection [(1)(a)] are not appropriate.” UCC §9-322 comment 7. As stated in this comment, these rules apply to *nonfiling collateral*, which is defined as “collateral of a type for which perfection may be achieved by a method other than filing (possession or control, mainly) and for which secured parties who so perfect generally do not expect or need to conduct a filing search.” *Id.* Thus, nonfiling collateral means “chattel paper, deposit accounts, negotiable documents, instruments, investment property, and letter-of-credit rights.” The term *filing collateral* means all other collateral—“accounts, commercial tort claims, general intangibles, goods, nonnegotiable documents, and payment intangibles.” *Id.*

b. Baseline Rule

§5.5 If a secured party has perfected its security interest in nonfiling collateral by means other than by filing a financing statement (e.g., by taking control of a deposit account or investment property), then the priority of that security interest in the original collateral will continue in proceeds if

- the security interest in proceeds is perfected, and
- the proceeds are either cash proceeds or nonfiling proceeds “of the same type” as the original collateral.

MCL 440.9322(3)(b). The operation of this rule is illustrated in UCC §9-322 comment 8, example 6:

SP-1 perfects its security interest in investment property by filing. SP-2 perfects subsequently by taking control of a certificated security. Debtor receives cash proceeds of the security (e.g., dividends deposited into Debtor’s deposit account). If the first-to-file-or-perfect rule of subsection [(1)(a)] were applied,