



The Arrow

STATE TAX LIEN DEFEATS PURCHASE MONEY SECURITY INTEREST

In a prior issue, we devoted an article to the type of security interest which is considered the "golden priority" among secured creditors – the purchase money security interest, or "PMSI" as it is commonly known. [See, "PMSI: The Golden Priority," Issue number 10, February, 1990.]

The Uniform Commercial Code, in section 9-107, says a security interest is a PMSI to the extent that it is: "(1) taken or retained by the seller of the collateral to secure all or part of its price; or (2) taken by a person who by making advances or incurring an obligation gives value to enable a debtor to acquire rights in or the use of collateral if such value is in fact so used."

Section 9-312 of the UCC generally gives a PMSI priority over conflicting security interests in the same collateral, and in the case of inventory, even allows a PMSI to leap-frog in priority over prior filed blanket liens on inventory under certain conditions. It is therefore no wonder that the PMSI is considered the "golden priority."

A recent decision from the Kentucky Court of Appeals, however, has now seriously undermined the value of a PMSI in the circumstance where the secured creditor's borrower has a prior state tax lien filed against it.

The case in question, Whayne Supply Company, Inc. v Commonwealth of Kentucky Revenue Cabinet, 42 K.L.S. 24, decided on February 10, 1995, although not yet final and therefore not binding precedent, holds that a prior filed state tax lien has priority in proceeds of collateral over a purchase money security interest.

The undisputed facts of the case indicate that Whayne entered into a six month operating lease with Panbowl Energy, Inc. for a Gardner-Denver drill. The lease agreement also gave Panbowl an option to purchase the equipment at any time before the expiration of the original six month lease.

Panbowl did exercise the option to purchase, and the unpaid balance of \$220,872.64 was financed by Whayne, which then took a security interest in the equipment, and filed its financing statement within the twenty days allowed for perfection under KRS 355.9-312(4). Upon the filing of its financing statement, Whayne thus had a properly perfected purchase money security interest in the drill. Unfortunately for Whayne, however, in December of the prior year, the Kentucky Revenue Cabinet had filed a Notice of State Tax Lien

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against Panbowl in the office of the Breathitt County Clerk, thereby invoking KRS 134.420 (2). The lien for unpaid taxes claimed to be against "all interest in property, either real or personal, tangible or intangible, in this State then owned or subsequently acquired" by the debtor Panbowl.

The plot thickened when Panbowl filed for Chapter 11 Bankruptcy in April of 1991. Whayne obtained an Order from the Bankruptcy Court for adequate protection payments from Panbowl, but the debtor defaulted and the drill was eventually surrendered to Whayne. Upon recovery of its collateral, Whayne notified

Panbowl's lienholders, including the Revenue Cabinet, of Wayne's intent to sell the equipment at auction. The auction of the drill realized proceeds of \$58,500. Wayne then notified Panbowl and its lienholders of the results of the auction, whereupon the Revenue Cabinet filed suit in Franklin Circuit Court seeking the proceeds from the sale of the equipment from Wayne.

Wayne moved for summary judgement on the basis that its PMSI was superior to all other security interests and liens on its collateral. The Revenue Cabinet responded with its own motion for summary judgement upon the basis that its lien was superior to Wayne's. The Franklin Circuit Court granted summary judgement in favor of the Revenue Cabinet, and Wayne naturally appealed to the Court of Appeals.

Wayne found little solace in the Court of Appeals, however, which "reluctantly" felt compelled to affirm the lower Court's decision although "we conclude that under the circumstances the end result is an absurd windfall for the Commonwealth in that money is taken from Wayne and not the debtor, Panbowl. Unfortunately, we are powerless to change that."

The Court of Appeals' majority opinion based its reasoning on a close reading of various statutes involved. KRS 355.9-102 (2), for example, states that Article 9--that part of the UCC governing secured transactions--does not generally apply to statutory liens such as that claimed by the Revenue Cabinet. The Court then relied upon KRS 134.420 (2) as the relevant statute to define the priority rules for statutory liens, which statute states in relevant part as follows: "The lien of the Commonwealth of Kentucky for taxes shall be superior to all liens and security interests created under Kentucky law except that nothing in this subsection shall be construed to alter or change in any way . . . the rights of any person taking the property or lien thereon for value without actual or constructive notice."

The Court went on to quote from KRS 134.420 (4) as follows:

The tax lien imposed by subsection (2) of this section shall not be valid as against any purchaser, judgement lien creditor, or holder of a security interest or mechanic's lien until notice of the tax lien has been filed by the Secretary of the Revenue Cabinet or his delegate with the County Clerk of any county or counties in which the taxpayer's business or residence is located, or in any county in which the taxpayer has an

interest in property. The recording of the tax lien shall constitute notice of both the original assessment and all subsequent assessments of liability against the same taxpayer. Upon request, the Revenue Cabinet shall disclose a specific amount of liability at a given date to any interested party legally entitled to the information.

The Court of Appeals reasoned that since the Revenue Cabinet had filed its notice in the office of the Breathitt County Clerk six months prior to Wayne filing its financing statement, that Wayne had constructive notice under the statute. The Court concluded: ". . . once a state tax lien is recorded, such lien has valid priority against the holder of a subsequently filed security interest, including the holder of a purchase money security interest."

This decision constitutes no less than a bombshell for creditors involved in secured transactions of the purchase money type in the Commonwealth of Kentucky.

Only two judges of the three judge Court of Appeals panel concurred in the decision, and Judge Howerton filed a vigorous dissent. "In my opinion, the result reached by the majority is unnecessary and unreasonable, and it creates a commercially-unworkable situation." Judge Howerton recognized that the majority opinion meant that vendors would have to search courthouse records for possible tax liens against prospective

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customers even if the sale and transfer to a buyer would be subjected to a perfected purchase money lien. His dissent goes on to state that historically a buyer's interest in the collateral of a secured transaction was limited to the value by which his investment exceeded the actual value of the property--in other words, the debtor's equity. "This was, and is, the underlying premise for a purchase money lien, whether we say the buyer acquired legal title to the property or only an equitable title or interest."

Thus, reasoned the dissenting Justice, the fact was that Panbowl never acquired any value sufficient to subject the equipment to the tax lien since it never acquired equity in the drill. "This is the only way to

make any sense out of this problem and to hold otherwise would turn Kentucky commercial transactions upside-down." [Editor's note: Obviously, that is exactly the effect of the majority opinion.]

Judge Howerton's dissent is worth quoting further:

When Whayne repossessed the equipment and had to resell it, Panbowl had no equity to which the tax lien of the Cabinet could attach. In fact, Panbowl owed a substantial deficiency to Whayne. Which lien has priority should only become a question when there is some interest of the debtor to be attached. In this case, Panbowl had none. Nevertheless, the majority opinion belabors the question of priority as it discusses the text of such statutes of KRS 355.9-312 (4) and (5), KRS 355.9-102 (2), and KRS 134.420(2) and (4). If Panbowl had any "equity" to attach, it may well be that the Cabinet's tax lien would be valid and enforceable. However, the facts of this situation simply do not allow for that result. The judgement of the Franklin Circuit Court should be reversed.

If the majority decision stands--the case is still pending upon further appeal--the whole idea of a uniform commercial code in the Commonwealth of Kentucky will once again be undermined. If the majority opinion is correct, (and remember, even the majority admits that it reached its decision reluctantly), then it appears absolutely necessary that the tax lien statute be amended so as to no longer allow the Revenue Cabinet to usurp priority from what commercial law has always intended to be the prevailing lien interest--the purchase money security interest. If the General Assembly really intended tax liens to defeat purchase money security interests, then it has established some very bad public policy which needs to be repealed.

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