

TIPPING THE SCALES



THE REALITIES OF ACCESSION PRIORITY

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Who has lien priority on items installed into leased equipment if a customer defaults? Julia Gavrilov explores this question and explains how lenders can ensure that the accessions they have financed will receive their warranted priority.

Lenders often finance items installed in and/or affixed to their customers' other leased or financed assets. When these items, known as "accessions," are part of the transaction, they are usually "perfected" by filing a UCC-1 Financing Statement in the jurisdiction where the customer is incorporated. The questions that arise, increasingly, are: "Who has lien priority if the customer defaults?" and "How do we ensure that we will have lien priority on our collateral?"

The answers require an understanding of the Uniform Commercial Code (UCC), engaging in proper due diligence and lien perfection practices and employing the appropriate language in transaction documents.



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The general proposition at the outset is if a lender financing an accession has a properly perfected purchase-money security interest in the accession, the accession lender's security interest will be afforded priority, regardless of whose security interest was perfected first.¹ Notwithstanding, accession lenders should consider the following nuances and/or exceptions:

MOTOR VEHICLES

An accession lender has no priority when its addition is affixed to a third party's titled vehicle, even if the accession lender has a purchase-money security interest and/or a timely and properly perfected security interest. UCC Section 9-335(d) provides that an accession lender's security interest is subordinate to a security interest in the whole, which would be perfected by compliance with that state's certificate of title statute.

Thus, even if the accession lender timely perfected its security interest, its security interest in the accession is subordinate to the holder of the lien noted on the title certificate of the vehicle. Possession of a certificate of title alone without the notation of the lien on the title is not sufficient to perfect the lien.

The policy behind this special “super priority” rule is that secured parties should be able to rely on a certificate of title without having to check the UCC records to determine whether accessions to the vehicle may be encumbered. This rule imposes a risk on financiers of accessions that will be affixed to titled motor vehicles. Accession lenders should proceed with caution and, where appropriate, seek acknowledgment from the motor vehicle lender.

EQUIPMENT

Where an accession lender does not have a purchase-money security interest and the addition is not installed and/or affixed to a motor vehicle, the general rule is the accession lender’s security interest has priority, notwithstanding if the accession is affixed to a larger piece of equipment subject to a security interest in favor of a third party, provided that:

1. The accession lender perfects its security interest before the accession attaches, and
2. The attachment does not cause the accession to become so incorporated into the larger equipment so as to render it collectively as one piece of equipment, e.g., a large set of integrated machinery where the removal of one piece would render the equipment useless.²

For example, a mail printing company obtains financing from a primary lender for the purchase of a printing press, in which the primary lender has a perfected security interest. The printing company then acquires from the accession lender an add-on used to produce certain types of mailers and grants a security interest in the add-on to the accession lender. Provided that the accession lender has perfected its security interest in the add-on before it is installed and/or affixed into the printing press, the accession lender’s security interest in the add-on has priority.

If, however, the accession lender perfects its security interest after the add-on is installed and/or affixed to the printing press, its interest is subordinate to the primary lender, but it is protected against subsequent secured parties and/or purchasers of the printing press.

LEASING ACCESSIONS

If a lessor is leasing an accession, the rights of lessors, lessees and their respective creditors in those accessions are governed by Article 2A of the UCC. Generally, if a lessor or lessee’s interests in the goods are identified in the lease before those goods become accessions, those interests are superior to all interests in the whole.³ Goods are deemed “identified” in a lease when the lease is made if the goods are in existence at that time. Identification otherwise

occurs when the goods are shipped or designated by the lessor as being subject to the lease.⁴ Revisiting the printing press example, provided that the lease agreement for the add-ons is in effect before the add-ons are shipped by the leasing company to the lessee, the accession lessor’s security interest in the add-ons has priority over the primary lender’s security interest in the printing press.

Moreover, if a lessor or lessee’s interests in the goods are identified in a lease at the time or after the goods became accessions, it is subordinate to the interests in the larger equipment that were existing at the time the lease was entered but takes precedent to all subsequently acquired interests in the whole. This is the case unless the existing lienholders in the whole have provided written consent to the lease or disclaimed an interest in the goods as part of the whole.⁵

ADDITIONAL EXCEPTIONS TO THE RULES

The UCC provides further limited exceptions to these rules of priority. The first exception is that the interests of the lessor and the lessee in the leased accession are subordinate to the interests of buyers and lessees of the whole in the ordinary course of business after the leased goods became accessions.⁶

The second exception is that the interests of the lessor and the lessee under the lease are subordinate to holders of pre-existing perfected security interests in the whole who make subsequent advances without knowledge of the lease.⁷ Therefore, if an accession lender with a lien on the accession provides additional financing secured by the accession before the accession lender learns of the existence of the lease, the lessor’s interests will be subordinate to those of the accession lender.

A third exception is when an existing lienholder provides written consent and/or disclaims its interest in the goods.⁸

THINGS TO CONSIDER

Whether you are leasing or financing goods that are and/or may become accessions, you make take the following preemptive measures to limit any potential subordination of your security interest in an accession:

- When financing a titled vehicle, a primary lender should insist that the financing include anything affixed to the vehicle.
- A lessor and/or accession lender should provide notification, such as a UCC notice, in accordance with the requirements for a properly perfected purchase-money security interest, to any secured creditors with liens on the equipment to which the accessions will be installed and/or affixed.

- A primary lender with a perfected security interest in equipment should always include boilerplate language in the security agreement to capture a security interest in accessions to the equipment.

- An accession lender should perform a UCC search to confirm whether a primary lender has any liens in the accessions to the equipment to avoid potential litigation and, where necessary, enter into an intercreditor agreement to establish whose lien in the accessions will be subordinate.

- A lessor in a true lease should file a UCC-1 Financing Statement out of an abundance of caution in case the lease is deemed to be a “finance lease” under Article 2A of the UCC.

- A lessor should include language in the lease prohibiting the attachment of its subject leased goods to other goods without the lessor’s prior written consent.

- A lessor should, where possible, require the lessee to mark the goods as leased from the lessor.

- The accession lender obtains written acknowledgments from the customer and any lender that the accession has not and will not be so integrated as to make it part of the underlying equipment.

- The subject equipment of a sale lease-back should be evaluated to confirm that the equipment has not already been affixed to another unit.

With a properly negotiated and carefully drafted agreement, the exercise of due diligence and the timely and proper perfection of the security interest, lender can better ensure accessions will receive the priority they warrant. •

¹UCC Section 9-324(a)

²UCC Section 9-335

³UCC Section 2A-310(2)

⁴UCC Section 2A-217

⁵UCC Section 2A-310(3)

⁶UCC Section 2A-310(4)(a)

⁷UCC Section 2A-310(4)(b)

⁸UCC Section 2A-310(3)

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