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PROTECTIONS FOR SELLERS UNDER UCC ARTICLES 2 AND 9

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The Players

- The Company – a supplier to Buyer.
- Buyer – one of the Company's customers, which purchases goods on open credit.
- CM – the Credit Manager of the Company.
- Debtor – a customer of the Company that purchases goods on secured credit.

Hypothetical # 1

Credit Manager ("CM") is reviewing her aged receivables, and she notices that Buyer, a long-time customer, is over 30 days past due. She recalls overhearing a conversation between two sales managers that they are working on an unusually large order for Buyer, scheduled to ship next week. What are her options?

1. First – what is the issue here?
   a. Answer – Does CM have "reasonable grounds for insecurity" that both the outstanding A/R and the new order will prove uncollectible?
   b. What other information might she want to have before making a decision?
      i. What is Buyer's payment history? Do they regularly pay 45+ days past due, but have never been a write-off?
      ii. Have they historically, consistently paid within "Net 15 day" terms?
      iii. Has there been any negative press or reporting on them in the financial news or industry sources?

2. Now, let's suppose that the answers to both ii. and iii. above are "Yes." Does CM have reasonable grounds for insecurity?
   - Applying a reasonableness standard, we believe that she does.
   - So, what are her options?

3. Section 2-609 of the UCC provides that CM may, in writing, demand that Buyer provide "adequate assurance of future performance."

4. What form might such "adequate assurance" take?
   a. CM could demand that Buyer bring its existing account current, and agree to C.O.D. terms for the new order (especially if the size of the new order is significantly in excess of the quantities Buyer normally purchases).
   b. CM could request a letter of credit as a means to assure payment.
   c. CM could demand that a creditworthy party either guarantee payment of the A/R, or pledge collateral to secure payment of the A/R.
   d. If typical within the industry, *e.g.*, a construction project, CM could request a surety bond.

Let's now change some of the facts of our hypothetical, to see how this affects our assessment of "reasonable grounds for insecurity."

1. Let's assume Buyer's payment history is that they regularly pay 45+ days past due, but that collection has never been a problem.
   a. Now the existing past due account appears to be consistent with an established pattern.
      i. No "reasonable grounds for insecurity" would exist here, without other, objective, troubling details.
      ii. The Company's prior acceptance of the late payments may also have established a "course of conduct" upon which Buyer is now entitled to rely.

2. What result if the existing past due account is not that unusual for Buyer, but there have been some negative articles in the financial press or in industry sources?
   a. Assuming the articles appear credible, they could establish a basis for "reasonable grounds."
3. What result if CM learns that Buyer's bank has taken some adverse action with respect to Buyer's credit facility?
   a. This clearly qualifies as a "reasonable ground for insecurity."
4. What if CM overheard someone she didn't know commenting at an industry conference that "Rumor has it Buyer is in big trouble"?
   a. Without more, rumor typically won't be enough to establish "reasonable grounds for insecurity."

5. What steps could CM take if she had concerns that the rumor was true, even if she couldn't rely solely on it?
   a. CM could call her contemporary at Buyer and ask them to update their credit references.
   b. She should ***probably not*** call other CM's to ask if they'd heard similar rumors.
      i. The simple act of asking the question serves to spread the rumor.
6. What if CM opens up the *Phoenix Business Journal* to a headline that reads "Buyer engages Lehman Bros. to help identify merger partners and to explore strategic alternatives"?
   a. This is corporate-speak for "We're in big trouble." Ask for adequate assurances.

7. In a situation where CM has "reasonable grounds for insecurity" and Buyer fails to provide "adequate assurances," what rights does the Company have?
    a. CM can instruct her sales team to suspend delivery of the pending order until "adequate assurances" are forthcoming.
    b. In doing so, CM's Company will not be in breach of the contract as long as its suspension of its own performance was "commercially reasonable."
    c. If Buyer fails to provide "reasonable assurances" within 30 days after a justified demand, Buyer is deemed to have repudiated, and thereby breached, the contract.
    d. This would allow CM's Company to pursue contract remedies for a breach.

Which of you have ever made a demand for adequate assurance before, and would you be willing to share with the group what were the circumstances and how did it work out for you?

Hypothetical # 2

The Company has just sent a large shipment of products by common carrier back to Buyer's manufacturing plant located on the East Coast. The next day, at an industry convention, the CFO of another supplier tells CM that he's heard rumors Buyer is in trouble financially. Based on these facts, what are CM's options? Does CM have authority to instruct the carrier NOT TO deliver the goods?

1. On these facts, CM does not. Can anyone explain why?
2. These rumors, without more, might not even amount to "reasonable grounds for insecurity," and exercising the right to stop delivery of goods in transit requires more.

3. The right to stoppage in transit, created by Section 2-705 of the UCC, requires as a precondition that Buyer be insolvent, which generally means unable to pay its debts as they mature. Which of the following qualify?
   a. What if the rumor was that Buyer is stretching its payment terms to everybody?
   b. What if it was "I hear some suppliers have sued Buyer"?
   c. What if it was "I heard that their Bank called their loan"?
   d. What about "Did you see that they filed for bankruptcy protection?"
   e. A and B don't qualify, while D certainly does. C is a closer call, but in most circumstances, we believe it should qualify.

4. Note that if the Company's shipment consisted of a number of complete truckloads of product, CM could demand stoppage of delivery if Buyer had failed to make a payment that was due from it prior to delivery, even if CM could not demonstrate that Buyer was in fact insolvent.

Stoppage of Delivery in Transit

Supposing CM concludes that Buyer is insolvent, how does CM exercise the Company's right to stop delivery? Remember, the product is on the trucks, and has been in transit for a few days. Diligence in exercising this right will be at a premium.

1. First of all, to be effective, exercise of this right must **actually prevent receipt** (actual or constructive) of the goods by Buyer.
   a. So, if by the time CM notifies the shipper, Buyer has already taken possession of the product, it's too late.
   b. Also, if the goods have been delivered to a warehouseman or bailee who has acknowledged to Buyer that they are holding the goods for Buyer, it's also too late.
   c. The same result occurs if the goods are represented by a negotiable document of title which has already been negotiated to Buyer.

2. The notice also has to be given with sufficient time that the carrier, exercising "reasonable diligence," will have time to prevent delivery.
   a. So, the phone call or e-mail an hour before the trucks pull into the loading bay at Buyer's East Coast facility may very well not be effective.
   b. **Act with urgency!**

3. Note that we are dealing here with *actual delivery* of the goods, not with the transfer of legal title or of risk of loss.
   a. Thus, even if the Company's sale terms are F.O.B. point of shipment, the Company can still exercise this right if it can prevent **actual delivery** of the goods.

4. If the right to stoppage in transit is timely and effectively exercised, then the party in possession of the goods must hold and deliver the goods according to the Company's instructions.
   a. But, the Company will be responsible for their charges, and for any damages that they incur as a result of complying with the demand to halt delivery.

Benefits vis-à-vis Other Creditors

Assuming that the Company provides notice timely and prevents actual delivery, there are two important side benefits that go along with the exercise of this right relative to potential competing creditors, as illustrated by the next two Slides.

1. What should the Company do if, as discussed in an earlier Slide, its basis for knowing that Buyer was insolvent is because Buyer had filed for bankruptcy protection?
    a. If possible, the Company can and should still exercise the right to stop delivery.
    b. The right to stoppage of delivery in transit **is not** prevented by the automatic stay in bankruptcy.
    c. However, the Company will have to get stay relief to recover its goods.
    d. This will prevent the Company's products from becoming an asset of the bankruptcy estate.

2. Stoppage will also prevent any blanket lien that Buyer's bank may have over "all goods now owned or hereafter acquired" from attaching to the Company's products.
   a. This avoids enhancing the collateral pool of the senior secured creditor at the Company’s expense.

Which of you have ever exercised your right to stop delivery in transit, and would you be willing to share your story with the group?

Hypothetical # 3

Same facts as Hypo # 2 above, except that, unfortunately, the industry convention where CM learns that Buyer is experiencing financial difficulty occurs a week after the product ships, rather than a day, and CM learns of the issue a day after the product was delivered to Buyer's plant. Is the Company out of luck? Do they just have to hope that the invoice will be paid?

Possibly, but not necessarily. What are CM's options, and how does she exercise them?

1. Because the goods have already been delivered, stoppage in transit is no longer an option.
2. If circumstances justify, however, the Company can demand reclamation of the goods.
   a. Section 2-702 of the UCC gives the Company a right to reclaim the goods sold, but only in narrow circumstances.

3. Several elements are required to successfully exercise the right of reclamation.
   a. Buyer must have received the goods on credit at a time when Buyer was insolvent.
      i. This is the same "insolvency" threshold as is necessary to justify a stoppage of delivery.
   b. Demand must be made within 10 days after Buyer receives delivery of the goods.
      i. Timing is critical – be sure you are able to prove both date of delivery and date of demand.
      ii. We recommend that, when making its demand, the Company identify the goods to be returned with as much specificity as is possible.
   c. Buyer must still be in possession of the goods when it receives the demand.
      i. Once Buyer sells the goods on, the right of reclamation expires.

4. Unlike stoppage of delivery, if Buyer's bank has a blanket lien on Buyer's assets, then Buyer's bank will have a superior claim against the goods once they come into Buyer's possession.
5. If all of the elements are in place and the right of reclamation is properly exercised, then the Company should send a carrier to retrieve its product as soon as possible.

6. In some situations, reclamation may be an impractical solution.
   a. For example, sale of materials to a construction site that have already been incorporated into the project.
   b. The Company should still make a demand and satisfy the requirements for exercising its rights if it can do so, however, because a claim for reclamation of goods sold will enjoy more favorable treatment in bankruptcy if Buyer subsequently files.

Which of you have ever exercised the right of reclamation, and would you be willing to share your story with the group?

UCC Article 9 – Secured Transactions

1. Article 9 of the UCC governs transactions that are intended to create a security interest.
   a. The classic example of such transactions are the security interests that a bank lender will take to provide it with a lien against collateral.
   b. That said, any device that is intended to perform the same function, to create an interest in property to secure some other obligation, will fall within the purview of Article 9, and will be subject to its rules.

Hypothetical # 4

The Company manufactures sophisticated office copy machines, some of which it sells directly to end-users, and some of which it sells through a chain of independent distributors. Because the machines are expensive, most customers, and virtually all distributors, finance their purchases. The Company's bank is willing to lend against these finance contracts as long as the Company has a perfected, purchase money security interest ("PMSI") in the products sold. The bank's relationship manager has asked the Company's newly hired CM to conduct an internal review of the program, to assure that all of the purchase money security interests have been properly documented. What steps does CM need to take to accomplish this?

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1. First, CM must confirm that there is a valid security interest from Debtor in favor of the Company. This requires:
   a. A Security Agreement granting a security interest in favor of the Company,
   b. Which reasonably identifies the collateral in which the lien has been created,
   c. And that Debtor has rights in the goods.

2. Next, CM needs to verify that the lien has been properly ***perfected*** by the filing of UCC financing statements in the correct locations. For most business organizations, this requires:
   a. Confirming the correct legal name for Debtor.
      i. For corporations, limited liability companies and limited partnerships, this is the name shown on the articles of incorporation or organization filed with the relevant state authority that brought Debtor into existence in the first place.
   b. Confirming the state in which Debtor is organized.
   c. Confirming that a UCC-1 has been filed with the proper office (typically, *but not always*, the Secretary of State) in the relevant state of formation.

d. Confirming that the name on the filed UCC-1 ***exactly matches*** the name shown on the organizational documents that are public records.

   i. We spoke last year about how even very minor discrepancies can cause the filing to become ineffective.

e. Confirming that the UCC-1 correctly describes the relevant collateral.

   i. While the UCC permits the use of "super-generic" descriptions of collateral on financing statements (*e.g.*, "all assets of Debtor"), based on the purchase money nature of this financing, our hypothetical is not a situation where use of an "all assets now owned or hereafter acquired" description would be appropriate.

   ii. The description on the UCC should not go beyond the scope of the grant in the Security Agreement.

   iii. Once a security interest has been created, the UCC permits a secured party to file a “conforming” financing statement without further authorization from the debtor.

3. The above points detail the steps necessary to verify a valid and perfected security interest. But CM is not done yet.
4. Additional steps are required to verify that the Company's security interest qualifies as a PMSI.

5. A PMSI is extremely beneficial, because it allows the Company to assert lien priority over a pre-existing (and therefore otherwise presumptively superior) lien against the same category of assets.
   a. For example, to allow the Company to jump in front of Debtor's bank's pre-existing lien on "all accounts, inventory, equipment, goods and general intangibles, now owned or hereafter acquired," as to the collateral subject to the PMSI.
6. To claim a PMSI, the Company must have searched to identify all prior competing lienholders, and must have given each of them written notice that the Company intended to assert a PMSI with respect to goods it was going to be selling to Debtor on credit.

7. When this notice must be given depends upon the nature of the goods in Debtor's hands.
    a. For any goods that will be held as <u>other than inventory</u>, the notice must be given within 20 days after the delivery of the goods to Debtor.
    b. But, for goods that will be held as <u>inventory</u>, both the notice to pre-existing creditors and the Company's UCC filing must occur <u>before</u> the goods are delivered to Debtor.
        i. The notice must advise the other creditors that the Company has or intends to obtain a PMSI in certain inventory of Debtor, and must describe the inventory.
        ii. Also, these notices must be renewed every 5 years if the PMSI financing remains in place, in a manner comparable to continuing a UCC Financing Statement, and thus we recommend that you docket them.

8. So, this is an important distinction, but the Company only sells copiers, and copiers are . . . well, copiers – aren't they? Why does it matter to CM?
   a. It matters to CM because the nature of the copiers, in terms of how the UCC would characterize them, is determined by their usage in the hands of the buyers.
   b. The copiers the Company sells to end-users are held by the end-users as equipment. Advance notice not required.
   c. But, the copiers sold to distributors are held as <u>inventory</u>, so both advance notice and advance filing are required.

9. Important cautionary note here – if Debtor has senior bank financing, the Company should ask Debtor to confirm that the PMSI will not breach some covenant prohibiting either other debt or the granting of other liens.
   a. Since the Company has to give the pre-existing lienholder notice in order to establish its PMSI, it isn't as if Debtor can keep it a secret.
   b. If there's a prohibition, the Company should ask Debtor to request a waiver.
   c. It's always better to avoid creating a potential event of default for your customer under their primary financing.

Which of your companies sell goods in reliance on purchase money security interests, and do you have past experiences that you'd like to share with the group?

Hypothetical # 5

Same facts as Hypo # 4, but now the CFO of the Company comes to CM and says the Company wants to start a "lease to own" program. The Company will "lease" copy machines to its customers, the Company will retain title and ownership of the copiers until the end of the lease, and the customer can then buy the machines for a nominal price at lease termination. CFO then says to CM "Since these will be leases, that doesn't involve UCC Article 9, Secured Transactions – correct? One goal of the program is to avoid bothersome requirements like filing UCC financing statements. These customers don't want to be named as a Debtor on a UCC-1."

How should CM answer?

WRONG! Remember, any type of transaction, regardless of how it is named or structured, that is intended to function as a security device <u>must</u> comply with UCC Article 9. So, the Company will still need to get the necessary information to file, and will need to file, UCC Financing Statements. Note that the UCC-1 has a box to check if the underlying transaction is characterized as a lease (as well as some other types of transactions that also fall within Article 9). Failure to file will mean that the Company's interests in the "leased" copiers will be unperfected, and other creditors (such as a bank lender to the customer) will have the opportunity to jump in front of the Company and claim a senior lien.

The foregoing is a discussion of general principles applicable to commercial transactions involving sales of goods and does not constitute legal advice. Legal advice can only be given in a situation involving identified parties and a specific transaction, and with respect to which an attorney-client relationship has been created. Delivery of a copy of this presentation does not create an attorney-client relationship between any recipient hereof and either the author or Gammage & Burnham, PLC.