Customer-Sponsored Credit Enhancement Programs (Consignment And PMSI): Reducing Supplier A/R And Preference Risk, Or Opening The Door For A Priority Fight?

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Recent Chapter 11 Consignment Challenges

Suppliers selling under customer-sponsored consignment programs are feeling the heat when their customers file Chapter 11. Recent examples of the Sports Authority, Hancock Fabrics and Family Christian Books are examples of the debtors, and their lenders, creating challenges to suppliers asserting senior creditor status through the consignment programs. The consignment challenge cuts at the essence of a supplier's credit making decision to a financially troubled customer, where the supplier may seek to reclaim its inventory and payment of the proceeds from the sale of its goods.

This article discusses customer-sponsored credit enhancements, and steps suppliers can take to reduce A/R risk and preference risk by complying with Article 9 of the UCC (Uniform Commercial Code).

A key supplier providing product to a customer scored as a high credit risk customer often attempts to negotiate a credit enhancement, such as consignment or purchase money security interest, to offset the increased A/R risk and potential preference risk. Many financially struggling customers now appreciate that a credit enhancement program they sponsor for their entire supply chain, rather than one-offs individually negotiated with a complaining supplier, can result in continued credit terms from the supply chain.

However, do these customer-sponsored credit enhancement programs (CSCEP) really reduce supplier A/R risk and preference risk, especially if that customer files Chapter 11? The credit team's chief task is managing credit risk, and their reporting responsibility is to assure management that these high risk customers have credit terms, and the risk profile has a floor.

Why Customer-Sponsored Credit Enhancements Programs?

An experienced credit team for a supplier reporting to management that a long-standing customer that is now scored as a high credit risk and no longer qualifies for terms, may recommend credit enhancements, such as a credit enhancement or PMSI, to keep the account on terms.

Customers, especially those publicly traded, understand that the supplier community closely monitors customer credit risk. Customers appreciate that, should they agree to negotiate a credit enhancement for a key supplier, other suppliers learning of this preferential treatment may react by pulling terms.

Likewise, if customers simply refuse to negotiate a credit enhancement program for suppliers, the supply chain may react by pulling terms, thereby negatively impacting the customers' cash flow and working capital. From this, some customers (especially retailers) recognize that rolling out a consignment or PMSI program allows them to encourage key suppliers to maintain terms. These customer-sponsored credit enhancement programs require the support of the customer's lender, given the lender has a floating lien on inventory.

Consignment and PMSI Programs

A consignment transaction is not a true sale until the customer (consignee) sells the goods; until then, title remains with the owner, usually the manufacturer (consignor) (supplier). The customer is obligated to pay the consignor from the proceeds of the sale of the merchandise. The consignee receives a recompense for making the sale. If the customer does not sell the goods after all, he may return them to the consignor without obligation. Title to goods on consignment remains with the consignor until the sale takes place.

Selling goods under a consignment program can create A/R risk from the customer's lender challenging the consignment. Inventory, or proceeds from the sale of the goods, may become a target of the customer's lender unless the supplier has complied with the UCC's requirements for perfecting a security interest in the goods. Where a supplier selling on consignment fails to comply with the UCC, the supplier risks a challenge to its goods on hand with the customer, or the proceeds from the sale of the goods, to a competing creditor.

Article 9 of the UCC's perfection requirements provides the means whereby a supplier can establish a valid security interest in their own goods, even when the goods have been delivered to the customer. Compliance with the perfection requirements of the UCC not only protects ownership of the goods; in the event of a dispute over the goods, the supplier may prevail over a competing creditor.

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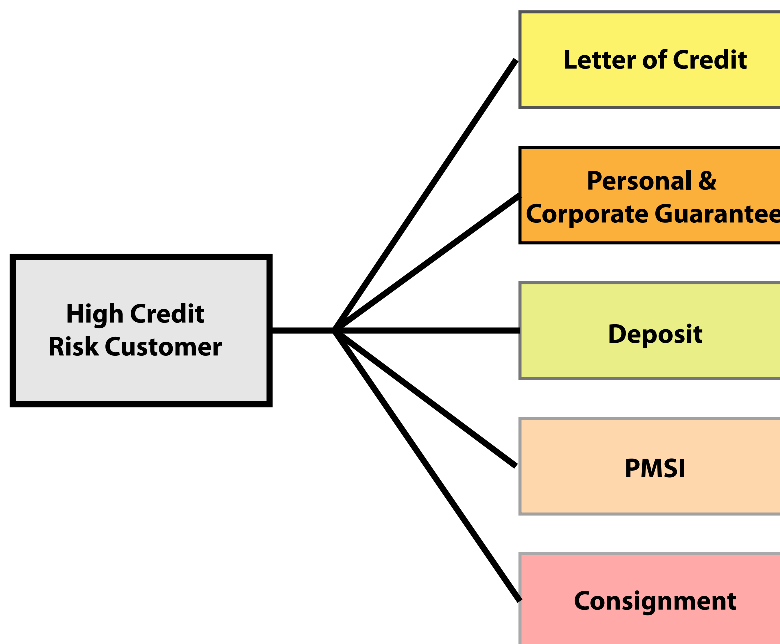
Perfecting a security interest in goods takes several steps that begin with the supplier. An agreement is executed describing the relationship of the parties, a description of the goods, and agreement that title to the goods only passes to buyers. Then the supplier completes a UCC-1 financing statement, which again describes the goods, and the goods are delivered on consignment. The supplier then files the statement with the filing office (usually the Secretary of State).

The supplier seeking to establish a security interest in its goods must take additional steps if the customer has a lender with a floating lien on inventory. For the supplier's security interest in its goods to prime the lien of the lender, the supplier should have its UCC-1 and consignment agreement recorded at the time the customer received the goods. Secondly, the supplier must give written notice to the lender, which should state the goods are subject to consignment. The supplier is then entitled to the proceeds from the sale of its goods or the return of the goods.



Debtor Known To Sell On Consignment

An exception to the supplier's need to comply with the Article 9 notice requirement is where the debtor is generally known by its creditors to be engaged in consignment sales. It is the supplier's burden to prove this. The competing argument by a debtor's lender is that the unperfected consignment serves as a secret lien. That is, from the lender's view, where the supplier has not filed a UCC1, a consignment arrangement appears as though it's an unsecured credit extension in which the supplier retains a secret lien in their goods. The lender's focus is that the consigned goods are part of the regular inventory of the customer and are subject to their lien rights.

Credit Enhancements Alternatives

As the chart highlights, suppliers and customers have options with credit enhancements. From the customer's perspective, a credit enhancement program across the supply chain to preserve credit terms is most effective with consignment and PMSI. By contrast, a personal or corporate guaranty are not practical, and an L/C program may not work as the financially struggling customer may not have the balance sheet to support an L/C program.

Do Customer-Sponsored Credit Enhancements Reduce A/R and Preference Risk?

For the customer, a credit enhancement program they offer the supply chain may result in continued trade terms from suppliers. For the supplier, customer programs may result in sales they may not otherwise make if they had cut the customer off. However, the takeaway from Sports Authority and like retailers is that burden is on the supplier, not the customer, to comply with the UCC-1 description and filing requirements, and notice to lenders, or possibly face a challenge from the customer's lender if that customer files bankruptcy.

The supplier who does not comply with the notice provisions of the UCC puts their goods at risk to existing and subsequent inventory lenders, unsecured creditors' committees or a bankruptcy trustee.

About the Author ...

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