

# 503(b)(9) Claims & Consignment Agreements are No Match for Properly Perfected UCCs

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Businesses file for bankruptcy protection; it is an unfortunate and uncontrollable reality. Considering the likelihood of debtor default, some creditors take unnecessary and avoidable risks relying on reactive recovery. Secured creditors, however, wisely mitigate these risks through the proactive protection afforded to creditors under Article 9 of the Uniform Commercial Code (UCC).

## Proactive Takes Priority

It's true. In bankruptcy, a properly perfected security interest, in compliance with UCC Article 9, has priority over unsecured creditors, creditors with administrative claims, 503(b)(9) claims, and even consignment agreements. If you attended CRF's Fall Forum in October 2018 in Salt Lake City, the [Bankruptcy Judge Panel - Three Judges/One Verdict](#) reinforced the priority UCC filings have over 503(b)(9) claims and consignment agreements.

The proof is in Sections 506 & 507 of the bankruptcy code. [Section 506](#) defines what is considered a secured claim and [Section 507](#) dictates the payout priority of claims.

Ultimately, the payout priority in a Chapter 11 filing is:

1. Secured Creditors (i.e. creditors who have a perfected security interest)
2. Administrative Expenses (i.e. costs associated with filing & processing the bankruptcy)
3. Unsecured Creditors (i.e. creditors without a security interest)

Secured creditors are paid before all other claims, to the extent of the pledged collateral. After secured creditors have been paid, payments are made to creditors with administrative claims. The administrative claims may include costs associated with the management of the bankruptcy (i.e. attorneys), post-petition claims and 503(b)(9) claims. Among those paid last in a bankruptcy, if paid at all, are general unsecured creditors.

## "Who Needs UCCs? We File 503(b)(9) Claims"

Yes, 503(b)(9) claims can be advantageous for an unsecured creditor. The bankruptcy code was amended in 2005 to include a new administrative claim: 503(b)(9). With the addition of 503(b)(9) claims, some creditors became complacent. The availability of a 503(b)(9) claim seemed to misleadingly allay creditor concerns: "Nah, I don't need UCC filings. We just file a 503(b)(9) to get paid." This somewhat false sense of security can easily cost creditors millions of dollars.

Under 503(b)(9), creditors may file a claim for "the value of any goods received by the debtor within the 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business."

As you can imagine, there are challenges with 503(b)(9) claims. High-profile cases are in heated debate over the definition of "received by" for the 20 day rule. And, of course, there is the question of what constitutes a "good" because services are not covered under these claims, and whether those goods have been sold in the ordinary course of business.

As an aside, a member of the panel at CRF's Fall Forum, Judge Christopher S. Sontchi, Chief Judge of The United States Bankruptcy Court for the District of Delaware, has presided over several cases determining "goods" and "receipt." Notably, in one case, Judge Sontchi looked to the UCC definition of goods and subsequently held that electricity is not a "good" under 503(b)(9).

To be clear, a UCC filing is not without potential obstacles. Your UCC must be properly perfected and there is a narrow margin for error. But, ensuring a UCC has been properly perfected is less cumbersome than proving goods are goods, defining date of receipt and verifying goods are sold during ordinary course of business.

## **We Sell on Consignment, No UCC Necessary**

“Why would I file a UCC if I’m selling on consignment?” Because the law allows you to establish priority as a secured creditor! A simple consignment agreement is often viewed by the courts as a “secret lien” and may not be enough to protect you if your debtor defaults or files for bankruptcy protection, as there is no legal/recorded document identifying your title to the goods provided to the debtor.

If the debtor files for bankruptcy protection, the inventory the debtor has on hand is gathered up and sold off to pay creditors (secured creditors first and then the unsecured creditors). Without the UCC filing identifying you as a secured creditor and specifically identifying your goods, the inventory you supplied automatically becomes property of the estate.

Is a UCC required for consignment sales? No. Creditors are not required to file a UCC. In default or bankruptcy situations, when a creditor is selling on consignment, there is a chance the creditor could argue it is “commonly understood” the debtor engages in consignment sales. But making that argument seems shaky at best, not to mention inefficient – how much time would it take to successfully make that argument vs. filing the UCC and granting a security interest at the beginning of the relationship?

## **UCCs are Payment Priority**

Please understand, UCCs are not a guarantee; there are no recovery guarantees in bankruptcy; after all, 100% of nothing is nothing. However, without a properly perfected UCC, you are just another unsecured creditor, wading in an overcrowded shallow pool for payment. With a properly perfected UCC, you are a payment priority.

### **About the Author and NCS:**

**Kristin Alford**, NCS Education & Marketing Specialist, has assisted credit professionals throughout the US and Canada to secure their receivables through the mechanic’s lien and UCC filing process.



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