



Practical Alternatives to Open Account Credit

Presented to Credit Research Foundation

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Introductory Materials

- What is this about?
- Defined terms
- Types of goods covered
- Types of transactions covered

What is this Presentation About?

- CRF Member is a seller of goods to its customer
- Customer's creditworthiness is inadequate
- Customer does not or cannot obtain a letter of credit from a bank to support its obligation to CRF member
- Customer cannot obtain a guaranty from an acceptable guarantor
- CRF Member decides to retain UCC security interest in the goods as collateral for the account receivable (in UCC speak, the "account")

Categories of Goods

- **Inventory:** CRF Member sells goods that its customer will re-sell to its customers, or lease to its customers, or use in providing services to its customers. These goods are “inventory” in the hands of the customer.
 - ✻ Inventory includes goods that the CRF Member’s customer incorporates into manufactured goods, such as raw materials.
 - ✻ Inventory includes goods that the CRF Member’s customer consumes in its business, such as gasoline in its delivery trucks.
- **Equipment:** goods that are not inventory. Examples: CRF Member sells shelving to a customer for the customer’s warehouse. The shelving is equipment in the hands of the customer.

Goods Not Covered by this Presentation

- Consumer goods — goods for personal, family, or household use in the hands of the customer.
- Farm products — most goods (including livestock) in the hands of a person engaged in the farming business
- Commingled goods — CRF Member sells raw materials to customer; customer combines with other raw materials to manufacture finished product.

Categories of Transactions Addressed by this Presentation

- CRF Member *sells* or *leases* goods that are **equipment** in the hands of its customer
- CRF Member sells goods that are **inventory** in the hands of its customer, including:
 - ☼ Regular sale or lease on open account credit.
 - ☼ Sale or Return — purchaser can return unsold goods to seller to discharge purchaser's account payable — often called “consignment” but not a consignment under UCC Article 9.
 - ☼ True consignments — see next slide.

Note on Consignments

- CRF Member's rights under a consignment are essentially the same as if the CRF Member has a security interest under Article 9.
 - ✻ A "true" consignment under Article 9 is a transaction in which CRF Member delivers goods to a person that will sell them, retain a commission, and send the proceeds, less the commission, to the CRF Member.
 - ◆ The customer does not purchase the goods from the CRF Member.
 - ◆ The customer can return unsold goods to the CRF Member
 - ◆ The customer can't be an auctioneer
 - ◆ The customer can't be known generally as a consignment shop
 - ◆ Not an Article 9 consignment if consumer goods or goods worth less than \$1,000

Note on “Sale or Return”

- Despite common usage, a sale or return is not a consignment
- In a sale or return, the CRF Member’s customer can return unsold inventory instead of paying the purchase price
- The CRF Member has no security interest in the goods sold to its customer merely because the customer can return the goods

Why have a security interest?

- If the CRF Member has a security interest in the goods sold to its customer, the CRF Member can foreclose on its “collateral” under Article 9 of the UCC to collect its account receivable.
- If the CRF Member does not have a security interest (having a security interest is “*attachment*”), it’s a general unsecured creditor.
- If the CRF Member’s security interest is not “*perfected*,” its security interest will disappear in its customer’s bankruptcy and some creditors and most purchasers will “take free” of the CRF Member’s security interest.
- If the CRF Member’s security interest is not *first priority*, the first priority secured creditor will get first crack at the collateral and the CRF Member will only get whatever remains, most likely nothing.

How to get a security interest?

- “Attachment” of a security interest requires:

- ✿ An agreement **authenticated** (means signed; electronic signatures ok, including emails) by the debtor and the CRF Member.

- ◆ Agreement must describe the collateral and the obligation it secures.

- ◆ Unilateral retention of title — such as in an invoice or shipping document — is not a sufficient agreement for this purpose.

- ✿ Customer must have “rights” in the collateral — will be satisfied when goods are delivered to the customer.

- ✿ “Value” must be given; again, will be satisfied when goods are delivered to the customer.

Descriptions of Collateral and Obligation

- It will suffice if the collateral description in the security agreement reads “all [inventory] [equipment] sold by [CRF Member] to [customer], including all past and all future sales, and all proceeds of that [inventory] [equipment].”
- It will suffice if the obligation description in the security agreement reads “all amounts owed by [customer] to [CRF Member], both presently and in the future.”

How to perfect a security interest?

- “**Perfection**” of a security interest can be accomplished in various ways but the only relevant method for purposes of this presentation is by filing a *UCC financing statement* against the CRF Member’s customer.
 - ☀ One UCC filing covering past, present, and future goods delivered to the CRF Member’s customer will suffice; no need for new filing for each delivery
- The booklet distributed to this conference describes in details the filing mechanism and various issues presented in connection with filing.

Note on Equipment Leases

- If a lease of equipment is a “true lease,” then it is not covered by Article 9 of the UCC and the CRF Member’s rights in the equipment are the rights of a lessor of the equipment, governed by Article 2A of the UCC.
- However, it is not always clear whether a lease is a true lease or a capital lease, so the prudent lessor includes provisions in the lease document to the effect that, if the transaction is characterized as a secured transaction, the lessee grants a security interest in the equipment to secure its obligations. And then the lessor (the CRF Member) *perfects* its security interest as if it were a seller.

“PMSI”—Purchase Money Security Interest

- A PMSI is a security interest that is collateral for the financing extended by the secured party to the debtor to finance the debtor’s acquisition of the collateral
- Every security interest in favor of a CRF Member to secure its customer’s account is a PMSI

Significance of PMSI

- If perfected in the correct manner, a PMSI confers first priority on the secured party. Example:
 - ✱ On January 1, Company X grants a security interest to its bank in all of X's inventory, equipment, and accounts
 - ✱ On March 1, CRF Member sells item of equipment to X; security interest granted by X to CRF Member is a PMSI
 - ✱ If perfected correctly, CRF Member's security interest takes priority over X's bank's security interest

Perfection of PMSI

- Perfection depends on whether the collateral is **equipment** or **inventory** in the hands of the CRF Member's customer

Perfection of Equipment PMSI

- The CRF Member must perfect by filing within 20 days after the delivery of the goods to the CRF Member's customer.
 - ☀ If perfection is late, it is only late with respect to previously delivered goods. It will still be timely with respect to goods subsequently delivered.

Perfection of Inventory PMSI

- The CRF Member must perfect by filing before the delivery of the goods to the CRF Member's customer.
- The CRF Member must send signed written notice in advance of delivery to its customer to every holder of a "conflicting security interest" (see next slide) in the same collateral
- The signed written notice must be received not earlier than five years before delivery to the CRF Member's customer
- The signed written notice must state that the CRF Member expects to have a PMSI in inventory and must describe the inventory

Inventory PMSI: Conflicting security interest?

- The *signed written notice* required to be sent in the case of an **inventory** PMSI must be sent to:
 - ☀ Every other secured party having a UCC filing against the CRF Member's customer, covering the same inventory, *on file* at the time the CRF Member files its UCC filing
 - ◆ A UCC filing covering all inventory would constitute “covering the same inventory”

Inventory PMSI: Signed Written Notice?

- The technical term used in the UCC is “authenticated notification”
- “Authenticated” would include manually signed but would also include any electronic symbol
- Practical recommendation: send a signed letter.

Inventory PMSI: On File?

- Note that the signed written notice must be delivered to any other secured party whose UCC financing statement is *on file* before the date on which the CRF Member files its financing statement
 - ☼ CRF Member must deal with time lags. Example:
 - ◆ Bank files against customer on April 1 in a jurisdiction in which the filing won't be identified in a search until April 10.
 - ◆ CRF Member files on April 5. It will not have found Bank's filing and it may therefore fail to send the signed written notice to Bank.
 - ◆ Solution: CRF Member files on April 5, searches on April 15, and sends the signed written notice to every other secured party on file before April 5.

What about Proceeds?

- To simplify: proceeds are what the CRF Member's customer receives when it disposes of the collateral.
- A CRF Member with a security interest in goods sold to its customer will have a security interest in the *identifiable* proceeds received by the customer.
- In the case of **inventory** sold by the CRF Member's customer, the proceeds will typically be cash, a check, a credit card receivable, an account, or perhaps "chattel paper."

Identifiable Proceeds?

- A secured party must be able to identify the proceeds received by its debtor upon disposition of collateral in order to establish that its security interest continues in the proceeds.
 - ◆ If the CRF Member's customer gets cash for the sale of goods and deposits the cash in its bank account, the amount credited to the bank account is identifiable proceeds.
 - ◆ If the CRF Member's customer gets a check for the sale of goods and deposits the check in its bank account, the amount credited to the bank account is identifiable proceeds.
 - ◆ Tracing the proceeds after that and is beyond the scope of this presentation.
- Credit card receivables and open accounts can readily be traced to particular sales of goods — but after the cash arrives it's harder to trace.
- Chattel paper can readily be traced to particular sales of goods. The rules concerning chattel paper are unique to chattel paper.

Disposition of Collateral: Equipment

- If a CRF Member's customer disposes of **equipment** without the consent of the CRF Member, the CRF Member's security interest will continue in the **equipment**, in the hands of the purchaser, as well as in the identifiable proceeds received by the customer.
- If the CRF Member's security interest is a PMSI and therefore has the first priority even if there is another secured party (e.g., the customer's bank) with a perfected security interest in the customer's equipment, the CRF Member's security interest in the identifiable proceeds of the equipment *may* have first priority.
 - ✻ If the identifiable proceeds are deposited in the customer's bank account and the bank has a perfected security interest in the bank account, the bank's security interest will take priority over the CRF Member's security interest in the identifiable proceeds no matter when the CRF Member filed its financing statement.

Disposition of Inventory for Account

- If a CRF Member's customer sells **inventory** to a "buyer in the ordinary course of business," the CRF Member's security interest will not continue in the inventory but the CRF Member will continue to have a security interest in the identifiable proceeds. Assume further that the *identifiable proceeds consists of an account*, which is turned into cash when collected.
 - ✿ If the CRF Member's bank filed its financing statement against the customer (assume it's a broad collateral description covering inventory, accounts, and general intangibles) before the CRF Member filed its financing statement. The bank's security interest will have priority over the CRF Member's security interest in the account.
 - ✿ If, when the account turns into cash and the cash is deposited in the customer's bank account and the bank has a perfected security interest in the bank account, the bank's security interest will take priority over the CRF Member's security interest in the identifiable proceeds no matter when the CRF Member filed its financing statement.

Disposition of Inventory for Chattel Paper

- Assume a CRF Member's customer sells **inventory** to a "*buyer in the ordinary course of business*" and receives *chattel paper* in payment.
 - ☀ To simplify, chattel paper is a conditional sale contract under which the customer promises (in writing) to pay the purchase price to the CRF Member and grants a security interest in the goods as collateral for that promise.
 - ☀ Example: the CRF Member manufactures and sells a construction machine to its customer; the customer sells a construction machine to a purchaser and the purchaser pays by entering a conditional sale contract.
- The CRF Member will have a security interest in the chattel paper. Assuming the CRF Member's security interest in the inventory was a PMSI, the CRF Member's security interest in the chattel paper will have first priority.

Further Rules on Chattel Paper

- As noted, the CRF Member will have first priority in the chattel paper assuming its security interest in the inventory was a PMSI.
- Now the question is: how does the CRF Member ensure that no other party gets a higher priority security interest in the chattel paper?
 - ✿ Make sure the chattel paper has a legend indicating it has been assigned to the CRF Member
 - ✿ The CRF Member should take possession of the chattel paper in the ordinary course of its business with the customer
 - ✿ If the chattel paper is electronic, the CRF Member should get “control” of the chattel paper in the ordinary course of its business with the customer

Recap of Inventory PMSI

- CRF Member must notify customer's other secured creditors.
 - ☼ Note that customer may have agreed with its bank or other creditors that it will not grant any other security interests.
- CRF Member must perfect by filing before delivery of goods to customer.
- If there is another secured creditor, CRF Member should assume the other secured creditor will very likely have priority in the proceeds of the sale of the inventory by the customer if:
 - ☼ The customer sells on open account to its customers, or
 - ☼ The customer deposits the checks, cash, or credit card receivables into a bank account with its bank that has a security interest in the bank account
- But if the customer sells to its customers for chattel paper, the CRF Member may be able to maintain a first priority security interest in the chattel paper and its proceeds.