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# Supplier Strategies for the Financially Distressed Buyer: Part I

While the stock market continually reached new highs last year, the pace of retail bankruptcies did not abate. In just the last year, Toys R Us, Gymboree, RadioShack, Payless ShoeSource, BCBG Max Azria, Eastern Outfitters and The Limited all filed for bankruptcy. This trend has continued into 2018, with the recent bankruptcy filing of The Bon-Ton Stores, and market watchers expect continued weakness in traditional retail.<sup>1</sup>

Given this uncertainty, it is a good time to review strategies for dealing with a financially distressed buyer. Part I of this article describes strategies to limit risk by selling on a secured basis or through a consignment arrangement. Part II of this article, which will be published in the next issue of *Business Credit*, discusses shortening credit terms, strategies for an insolvent buyer, and how different credit strategies may impact the seller's preference liability in a subsequent bankruptcy filing.

## Purchase Money Security Interests

If shortening credit terms is not possible, another option is to secure the buyer's obligation by obtaining a first priority security interest in the goods that are being delivered under Article 9 of the Uniform Commercial Code ("UCC"), which is referred to as "purchase money security interest" (hereinafter, "PMSI").<sup>2</sup> By obtaining a PMSI, the seller gets a lien on the sold goods and their cash proceeds (with some exceptions) that has priority over previously perfected liens on the buyer's inventory.

To obtain a PMSI in the sold goods, the seller must take three steps *before* delivering the goods to the buyer. First, the parties must enter into a security agreement describing the goods and granting a security interest in them.<sup>3</sup> Second, a UCC-1 financing statement identifying the collateral must be filed.<sup>4</sup> Third, to obtain priority over other creditors' existing liens, the seller must deliver an authenticated (i.e., signed) notification to the previously perfected lienholders stating that the seller has or expects to acquire a PMSI in the inventory of the buyer and describing such inventory.<sup>5</sup> In a long-running credit relationship, the seller must send a new notification to holders of conflicting security interests and file a continuation of the financing statement every five years to maintain the PMSI's perfection.<sup>6</sup>

While PMSI provides the seller with substantial protection, the devil is in the details. The failure to properly



perfect the PMSI may cause the seller's claim to be treated as unsecured in a subsequent bankruptcy case.<sup>7</sup> And, even if the PMSI is perfected, the failure to provide timely notification to prior lienholders would render the PMSI junior to existing liens.<sup>8</sup>

The seller's PMSI would also apply to identifiable cash proceeds received by the buyer on or before of the delivery of its inventory to the buyer's customer.<sup>9</sup> However, to protect the seller's interest in cash proceeds, it should consider requiring the buyer to maintain a segregated account to receive the proceeds from the sale of the goods to avoid commingling these funds with the buyer's other cash assets.<sup>10</sup>

## Consignment

Another option is to sell goods on consignment. Generally, a consignor delivers a product to a consignee, who then sells that product to its customers, and remits the purchase price back to the consignor less its commission.

A consignment of goods that falls within Article 9 of the UCC<sup>11</sup> will be treated like PMSI: the consignor is a secured creditor with a PMSI in the consigned goods.<sup>12</sup> Thus, to preserve a PMSI in the consigned goods, the consignor must take the steps (discussed above) to perfect its interest in the consigned goods before delivery, including providing notification to existing lienholders before the consigned goods are delivered.<sup>13</sup> The purpose of this is to protect the creditors of the consignee from secret liens on its inventory.<sup>14</sup>

Again, the devil is in the details. If the PMSI is timely perfected, the consignor would have a security interest in the consigned goods superior to the rights of a creditor with an existing lien on inventory. However, if the consignor fails to timely send notification to existing lienholders, the consignor's interests in the consigned goods

would be subordinate to the existing liens.<sup>15</sup> Moreover, if the consignor does not timely file a UCC-1 financing statement (or timely continue that financing statement), the consignor would lose all of its rights to the consigned goods and be an unsecured creditor in a subsequent bankruptcy of the consignee.<sup>16</sup>

The experience of many consignors in the Sports Authority bankruptcy case is a cautionary tale. In this case, the debtors and their secured lender challenged whether the entities that consigned goods to Sports Authority held perfected PMSI in the consigned goods. They asserted that the consignors either lacked a perfected security interest in the consigned goods because they did not timely file or continue a UCC-1 financing statement, or if they did timely file a financing statement, the consignors' interests were junior to the prior lien of the secured lender because they failed to deliver the authenticated notice to the secured lender before delivering the consigned goods.<sup>17</sup> Many of these cases settled with the settling consignors relinquishing to the secured lender a substantial amount of the sale proceeds of the consigned goods, with the vast majority of consignors receiving only 25-40% of the proceeds.<sup>18</sup>

Finally, if the consignment does not fall within the ambit of Article 9 of the UCC,<sup>19</sup> the arrangement may be governed by Article 2 of the UCC, or other applicable state law. However, even if the consignor believes the arrangement is not governed by Article 9, it should consider taking the steps to perfect its PMSI in the event the nature of the consignment is later challenged.

## Next Issue: Part II

Having considered selling goods on a secured or consignment basis, Part II of this article focuses on strategies to shorten credit terms on an unsecured basis, remedies when a buyer is insolvent, and how different credit strategies may impact the seller's preference liability in a subsequent bankruptcy filing. ■

1. See, e.g., L. Thomas, *Retail Bankruptcies Will Continue to Rock Retail in 2018*, cnbc.com, Dec. 13, 2017, available at: <http://www.cnbc.com/2017/12/13/bankruptcies-will-continue-to-rock-retail-in-2018-watch-these-trends.html>.

2. A seller can obtain PMSI in goods and software under Article 9 of the Uniform Commercial Code ("UCC"). UCC § 9-103; 9-324 cmt. 2. The steps to perfect a PMSI vary based on whether the collateral is software or goods, or what specific type of good it is (such as inventory, equipment, or livestock). UCC § 9-324. For the purposes of this article, we only discuss how to obtain a PMSI in "goods" that will be "inventory" of the buyer, as those terms are defined in the UCC.

3. UCC § 9-203 (describing attachment of security interest).

4. UCC § 9-310 (governing filing of financing statement). The methods and procedures of obtaining a perfected security interest in various types of collateral are beyond the scope of this article.

5. UCC § 9-324(b).

6. UCC §§ 9-324(b) and 9-515(a).

7. See 11 U.S.C. § 544(b)(1).

8. See UCC § 9-322(a).

9. UCC 9-324(b). However, it should be noted that the PMSI will not apply to any accounts resulting from the sale of inventory. See UCC § 9-324, cmt. 8. The seller can take a security interest in accounts and file a UCC-1 financing statement to perfect that security interest, but this lien would be subject to the default first in time rules under UCC § 9-322(a).

10. See, e.g., *Van Diest Supply Co. v. Shelby Cty. State Bank*, 425 F.3d 437, 443 (7th Cir. 2005) (finding that because, in part, holder of PMSI failed to identify any cash proceeds that were commingled by debtor in general business account, creditor did not have priority over prior security interest).

11. "Consignment" under Article 9 means a "transaction, regardless of its form, in which a person delivers goods to a merchant for the purpose of sale and:

(A) the merchant:

- (i) deals in goods of that kind under a name other than the name of the person making delivery;
- (ii) is not an auctioneer; and
- (iii) is not generally known by its creditors to be substantially engaged in selling the goods of others;

(B) with respect to each delivery, the aggregate value of the goods is \$1,000 or more at the time of delivery;

(C) the goods are not consumer goods immediately before delivery; and

(D) the transaction does not create a security interest that secures an obligation." UCC § 9-102(a)(20).

12. See UCC § 9-103(d); 5 *Collier on Bankruptcy* (16th Ed.) ¶ 541.05[1][b].

13. See UCC § 9-324(b); *In re TSAWD Holdings, Inc.*, 565 B.R. 292, 298-99 (Bankr. D. Del. 2017).

14. See *In re Valley Media, Inc.*, 279 B.R. 105, 125 (Bankr. D. Del. 2002).

15. See UCC § 9-319(a) & cmt. 3; *TSAWD Holdings, Inc.*, 565 B.R. at 299.

16. See 11 U.S.C. § 544(a); 5 *Collier on Bankruptcy* (16th Ed.) ¶ 541.05[1][b].

17. See, e.g., *TSA Stores, Inc., et al. v. Slendertone Distribution, Inc.*, Adv. Pro. No. 16-50213, Complaint, ECF No. 1 (Bankr. D. Del. March 15, 2016); *TSA Stores Inc. v. Performance Apparel Corp. a/k/a/ Hot Chilly's Inc.* (*In re TSAWD Holdings Inc., et al.*), Adv. Pro. No. 16-50317, Memorandum of Law in Support of Term Loan Agent's Motion for Partial Judgment on the Pleadings, ECF No. 30, ¶¶ 42-44 (Bankr. D. Del. July 19, 2016).

18. *In re Sports Authority Holdings, Inc.*, Case No. 16-10527, Joint Motion for an Order, Pursuant to Bankruptcy Code Section 105(A) and Bankruptcy Rule 9019, Approving the Settlement Agreement By and Among the Debtors, Term Loan Agent, and Certain Consignment Vendors Party Thereto, (Bankr. D. Del. June 30, 2016); *In re Sports Authority Holdings, Inc.*, Case No. 16-10527, Order, Pursuant to Bankruptcy Code Section 105(A) and Bankruptcy Rule 9019, Approving the Settlement Agreement By and Among the Debtors, Term Loan Agent, and Certain Consignment Vendors Party Thereto, ECF No. 2434 (Bankr. D. Del. July 7, 2016).

19. For example, the consignment would not be governed by Article 9 if the consignee was generally known by its creditors to be substantially engaged in selling the goods of others. See UCC § 9-102(a)(20); *In re Valley Media, Inc.*, 279 B.R. at 123.

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