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Supplier Strategies for the Financially Distressed Buyer

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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 in 2018, with the recent bankruptcy filing of The Bon-Ton Stores, and market watchers expect continued weakness in traditional retail.[1]

Given this uncertainty, it is a good time to review strategies for dealing with a financially distressed buyer. Set forth below are a variety of options to limit the seller's risk followed by a brief discussion on how those strategies may impact the seller's preference liability in a subsequent bankruptcy filing.

Shorten Credit Terms

One of the first steps that a seller may consider is shortening credit terms. Cash in advance ("CIA") or cash on delivery ("COD") is the safest option for the seller both for credit risk and preference risk (discussed below). However, many struggling customers will not be able to pay on such terms. In that case, the seller can continue to extend credit, but shorten the period for payment and amount of credit. The process to put in place tightened credit terms will depend on whether the supplier and customer have a contract and the terms of such contract. If the parties' contract governs credit terms for accepted orders, the seller should explore the ability to reject new orders until credit terms are renegotiated. In the absence of such contract, a seller of goods may be able to unilaterally impose new credit terms.[2]

When shortening credit terms, a seller of goods should consider requiring payment within twenty days of the buyer's receipt of the goods. By doing so, the seller limits its risk in the event of a bankruptcy because the Bankruptcy Code provides that amounts owed for goods received by the debtor within twenty days of the filing are entitled to administrative expense priority.[3] These claims are entitled to payment before any other unsecured claims and must be paid in full to confirm a plan of reorganization.[4]

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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 *See* Uniform Commercial Code ("UCC") § 2–310 (providing default rule for sale of goods that payment is due upon delivery, unless altered by agreement of parties).

3 11 U.S.C. § 503(b)(9). A recent case held that the twenty-day period is measured from the date that the debtor takes actual, physical receipt of the goods. *In re World Imports, Ltd.*, 862 F.3d 338, 346 (3d Cir. 2017). Moreover, this relief is solely afforded to the sale of "goods." While the Bankruptcy Code does not define the term "goods," courts have used the UCC's definition. See *In re Great Atl. & Pac. Tea Co., Inc.,* 498 B.R. 19, 25 (S.D.N.Y. 2013). The UCC defines "goods" to include "all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action. . . . ." UCC § 2–105(1).

4 11 U.S.C. § 1129(a)(9)(A).

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").[5] 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.[6] Second, a UCC–1 financing statement identifying the collateral must be filed.[7] Third, to obtain priority over 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.[8] 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.[9]

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.[10] And, even if the PMSI is perfected, the failure to provide timely notification to prior lienholders would render the PMSI junior to existing liens.[11]

The seller's PMSI would also apply to identifiable cash proceeds received by the buyer on or before the delivery of its inventory to the buyer's customer.[12] 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.[13]

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.

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5 A seller can obtain PMSI in goods and software under Article 9. UCC § 9-103; 9-324 cmt. 2. The steps to perfect a PMSI varies 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.

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

7 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.

8 UCC § 9-324(b).

9 UCC §§ 9-324(b) and 9-515(a).

10 *See* 11 U.S.C. § 544(b)(1).

11 *See* UCC § 9-322(a).

12 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).

13 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 collateral that were commingled by debtor in general business account, creditor did not have priority over prior security interest).

A consignment of goods that falls within Article 9 of the UCC[14] will be treated like PMSI: the consignor is a secured creditor with a PMSI in the consigned goods.[15] 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.[16] The purpose of this is to protect the creditors of the consignee from secret liens on its inventory.[17]

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.[18] 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.[19]

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.[20] 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.[21]

Finally, if the consignment does not fall within the ambit of Article 9 of the UCC,[22] 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.

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14 "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).

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

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

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

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

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

20 *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).

21 *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).

22 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.

The Insolvent Buyer of Goods

A seller continuing to sell on unsecured credit terms may learn that it has pending orders to an insolvent buyer. If that occurs, Article 2 of the UCC provides a seller of goods with remedies to avoid making a bad situation worse. A seller can refuse to deliver goods to an insolvent buyer, except for cash payment for all the goods previously delivered under the parties' contract.[23] If the goods have been placed in the possession of a carrier or other bailee by the time the buyer's insolvency is discovered, the seller can direct that the goods be returned to it.[24] Finally, a seller who discovers that a buyer received goods on credit while insolvent, can reclaim the goods by making demand within ten days of receipt.[25]

The right to exercise such remedies is based on the buyer's insolvency, which is measured in any of three ways: (i) if the buyer has generally ceased paying its debts in ordinary course of business (unless the subject of a bona fide dispute); (ii) the buyer is unable to pay its debts as they become due; or (iii) the buyer's liabilities exceed its assets.[26] Accordingly, a seller concerned about a buyer's solvency should closely review its credit reports and public filings (if any), or consider requesting certified financial statements before continuing to ship.

A Few Words about Preferential Transfers

The Bankruptcy Code provides a debtor or its trustee with the right to recover payments made by the debtor to a creditor in the 90 days before its bankruptcy filing if those payments were made on account of a debt that it owed to the creditor at the time the transfer was made and allowed the creditor to receive more than it would in a Chapter 7 liquidation.[27] The concept is to allow the debtor to recover transfers that may have "preferred" certain creditors over others, and then redistribute those amounts to all creditors more equitably. Because pursuing some of the above strategies may impact the seller's preference liability risk, we briefly highlight the interplay between some of those credit strategies and the seller's preference risk.

Shortened Credit Terms

There is a strong argument that COD and CIA payments are not subject to recovery as preferences. Generally, if there is no obligation to pay until the good is delivered, COD or CIA payments will not fall within the definition of a preference because the payment would be made before there was a debt owed by the buyer.[28]

On the other hand, shortening credit terms in the in the weeks and months before a bankruptcy filing may weaken the seller's ordinary course of business defense. The Bankruptcy Code provides that payments made in the ordinary course of business of the debtor and the transferee, which pay debts incurred in the ordinary course of parties' business, are exempt from recovery as preferences.[29] Courts evaluate

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23 UCC § 2–702(1).
24 UCC § 2-705. If the buyer files bankruptcy after the order is accepted but before the buyer received the goods, case law suggests that the seller can stop delivery of the goods, without violating the automatic stay that arises upon a bankruptcy filing. *In re Nat'l Sugar Ref. Co.*, 27 B.R. 565, 573 (S.D.N.Y. 1983).
25 UCC § 2-702(2). The ten day window to make demand is not applicable if the buyer has misrepresented its solvency to the seller in writing in the three months before delivery. *Id.*
26 UCC § 1–201(23); 11 U.S.C. § 101(32).
27 11 U.S.C. § 547(b).
28 *See* 11 U.S.C. § 547(b)(2). Alternatively, these payments may come within the affirmative defense as a contemporaneous exchange for value. 11 U.S.C. § 547(c)(1); see *In re Chez Foley, Inc.,* 211 B.R. 25, 27 (Bankr. D. Minn. 1997) (trustee acknowledging that COD payments were subject to contemporaneous exchange defense).
29 11 U.S.C. § 547(c)(2).

many factors to determine whether payments were made in the ordinary course of business, including the timing of payments. If the allegedly preferential payments are made much quicker than the parties' prior course of dealing, this will often weigh against a finding that the payments were made in the ordinary course of business.

The tail should not wag the dog though. A seller's credit strategies should not be overly governed by preference liability risk because such liability is contingent on a bankruptcy filing and prosecution of such claims. Even if such claims are asserted, they are often resolved at a discount. It is therefore better to be paid and risk a preference claim, than not to be paid at all.

PMSI

Payments received to pay a fully secured obligation will not be recoverable as preferences. A preferential transfer must be one in which the creditor received more than it would have received had the debtor been liquidated in Chapter 7.[30] Thus, payments received on account of a properly perfected PMSI in the goods sold should not be recoverable as preferences.[31]

Conclusion

It is possible to take concrete steps to reduce a seller's credit risk from a distressed customer. However, the right approach will be driven by many factors, such as the relationship with the customer, the customer's particular financial circumstances, the terms of the parties' agreement (if any), and the governing law. Once a credit strategy is decided upon, the seller should ensure that it is properly effectuated under the governing law, and remain alert to changes in the buyer's financial condition that may warrant additional protections.

Questions or Assistance:

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30 *See* generally 5 *Collier on Bankruptcy* (16th Ed.) ¶ 547.03[7].

31 The Bankruptcy Code also shields the avoidance of the grant of a PMSI during the preference period under certain circumstances. See 11 U.S.C. § 547(c)(3). There should be a similar defense to preference recovery for payments on account of the sale of consigned goods if the consignor has a properly perfected PMSI in the underlying goods.

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