KRIEG DEVAULT

# Insights

## Protecting Against Insolvency Risks related to Customers and Suppliers

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Credit risk issues permeate supply chain relationships in both directions. Current circumstances seem to exacerbate these considerations as the supply chain and pervasive pandemic effects continue to impact all sectors at all levels. The following outline identifies some potential problems and possible solutions related to selling to and buying from companies that are insolvent, or in danger of becoming so.

**THE GAMES**

***With Customers:*** Should you sell on a secured or unsecured basis?

- If you are secured, then you are relatively sure that you will get paid, or you can get back your inventory, and receive some form of adequate protection in a bankruptcy case if your collateral is declining in value.
- If you are unsecured and you have no reclamation rights, then you are not going to get paid. You can ship on a COD basis for additional sales, but you will not be able to collect on an outstanding balance.
- You need to balance a tight credit policy against retaining or improving sales. A tighter credit policy (including selling on a secured basis) may reduce sales, but it may also help eliminate 'phantom' sales – namely, those sales for which you have incurred all of your expenses but for which you will not get paid in full or at all.
- Customers may have a secured lending arrangement in place with their own bank. Typical lending structures will require the customer to get the consent of its lender, and depending on advance formulas and borrowing base requirements, a security interest obtained by a supplier in its own products may reduce credit availability of the customer at its own bank.
- If your goods are incorporated into other goods and you have a security interest in only your own goods, then you may face arguments over allocation of proceeds from the sale of the collateral.

***With Suppliers:*** Are the goods you are purchasing "identified to a contract"?

- A sale of inventory in the ordinary course of business will usually cut off a lien granted by a supplier to another creditor.
- Has there been a sale? A buyer in the ordinary course of business takes free of any security interest created by a seller (UCC 9.1-320)

- If goods have been "identified to the contract," then they probably will be safe from the creditors of your supplier (UCC 2-402, 2-501 and 2-502).
- If not "identified to the contract" and you have not received the goods, you may run the risk of creditors of your supplier retaining a lien on the goods, even if you have made substantial payments.

**THE RULES**

Article 9 of the Uniform Commercial Code [renumbered Article 9.1 in Indiana] provides the ground rules for these questions at the state level.

- Creation of a security interest is by means of written security agreement "authenticated" by a debtor (UCC 9.1-203).
- Perfection, the effect of perfection, nonperfection and priority of a security interest in inventory is governed by the law of the location of the debtor (UCC 9.1-301). If the debtor is an entity, it is located in its state of organization (UCC-9-307).
- Signing a security agreement is authorization to file a financing statement (UCC 9.1-509). Financing statements do not need to be signed.
- Perfection of a security interest in inventory is accomplished by means of filing a financing statement (UCC 9.1-310). A financing statement against a business entity must contain a debtor's correct legal name, a mailing address, the type of organization and any organization ID, and a description of the collateral. It must also contain the name and a mailing address for the secured party. (UCC 9.1-502, 9-516) Financing statements are filed with the secretary of state (or equivalent) in the state where the debtor is located (UCC 9.1-501).
- A financing statement is good for 5 years and, if necessary, must be continued within the 6 months preceding the 5th anniversary of filing (UCC 9.1-501).
- First to file a financing statement is generally first in priority (UCC 9.1-322). Thus, if there is a lien already filed covering inventory, your newly-filed lien will be junior to the senior lien unless you can claim the status of a purchase money security interest ("***PMSI***") for your lien.
- A PMSI in inventory can take priority over a previously-filed lien with respect to that inventory, any chattel paper or instrument constituting proceeds, or identifiable cash proceeds (but not in an account receivable) (UCC 9.1-322), if
  - the PMSI is perfected when the debtor receives possession of the inventory;
  - the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
  - the holder of the conflicting security interest receives the notification within five (5) years before the debtor receives possession of the inventory; and
  - the notification states that the person sending the notification has or expects to acquire a PMSI in inventory of the debtor and describes the inventory.
- The super-priority of a PMSI in inventory will **not** carry through to accounts receivable of your customer.
- Collateral must be disposed of in a commercially reasonable manner (UCC 9.1-610). Notice of disposition of collateral must be sent to the debtor, secondary obligors and to other lienholders identified in a UCC search conducted prior to disposition.

The United States Bankruptcy Code provides the ground rules at the federal level once a bankruptcy filing occurs. For planning purposes, the impact of the Bankruptcy Code influences decisions made during the pre-filing timeframe.

- Filing of a bankruptcy petition creates an automatic stay, which is a federal statutory injunction that prevents further collection activities related to outstanding balances.
- If you are secured, you are in a good position and will most likely receive payment equivalent to at least the value of your collateral.
- If you are over-secured, you can collect all amounts due to you.
- If you are undersecured you are likely to be paid an amount equivalent to the market value of your collateral at the inception of the case.
- If you are unsecured, you will be paid what other unsecured creditors receive, which generally is not very much.
- Even if you are unsecured, you may have reclamation rights. Where goods are sold on credit to an insolvent buyer, the seller may reclaim the goods upon demand made within ten days after the buyer's receipt of them. Uniform Commercial Code § 2-702; see, e.g., Ind. Code § 26-1-2-702(b). Where the buyer gets the goods but then files bankruptcy, the United States Bankruptcy Code, 11 U.S.C. §§ 101, *et seq.* (the "***Bankruptcy Code***"), expands the rights of a reclaiming creditor/seller by allowing the creditor/seller to reclaim the goods if (1) the debtor/buyer received the goods while it was insolvent and not later than 45 days before the bankruptcy filing, and (2) the creditor/seller makes a written reclamation demand on the debtor/buyer (a) not later than 45 days after the date the debtor/buyer received the goods, or (b) not later than 20 days after the commencement of the case, if the 45-day period expires after the case is filed. Bankruptcy Code § 546(c)(1). The creditor/seller's right of reclamation is subject to the prior rights of creditors holding security interests in those goods, which typically will be financial institutions. A reclamation right must be exercised promptly as the right is lost with respect to any goods the debtor already has sold before receiving the written demand.
- Even if you do not have a reclamation claim (either because the goods were sold, or due to a failure to file a timely claim), if the goods were received by the debtor/buyer within 20 days before the filing of the debtor/buyer's bankruptcy petition, the Bankruptcy Code gives an administrative priority claim for goods sold by the debtor/buyer in the ordinary course of its business. Bankruptcy Code § 503(b)(9). In a Chapter 11 case a debtor is required to pay all administrative claims in full and in cash as of the effective date of the plan, as a condition for the confirmation of any such Chapter 11 plan.
- If the value of your collateral is declining, you may be entitled to receive an "adequate protection" payment.
- Securing old account balances with a new security interest may constitute a preference. This can result in the new security interest being voided.
- Payments made within the 90 days preceding a bankruptcy filing, if not made in the ordinary course of business (or otherwise protected by the Bankruptcy Code), may also constitute avoidable preferences (i.e., you can be forced to pay back preferential payments).

**THE TACTICS**

**For Customers to whom you are selling:**

- Get secured. If you are secured, you are a 500 lb. gorilla in a bankruptcy case. If you are unsecured, you are just along for the ride.
- If you are unsecured and learn of a bankruptcy filing, quickly analyze whether you have any reclamation rights or administrative expense rights and assert those rights. If you do, you need to act promptly.
- If you are going to become secured, accurate information on your customer is critical (i.e., correct legal name, state of organization, organizational ID#, etc.). A security agreement and financing statements should be prepared using the correct legal name of the customer. It would be prudent to get copies of an entity's organizational documents (i.e., articles of incorporation, by-laws, articles of organization, operating agreement). A significant amount of this information is online.
- Do a UCC search and identify any liens which may have priority over yours. Searches must be done in the location of the debtor (i.e., the state where it is organized). Searches must also be done using the correct legal name of the debtor. These can be done online in a large number of states.
- Create a security agreement to be signed by the customer. This may be built into other contracts if the other contract is signed by the debtor/customer. The collateral description need not be specific items identified by serial nos., but may be described by type.
- Send notice of a purchase money security interest to any blanket lienholder (but think about whether this will affect any arrangement your customer has with that lienholder). The notice need not identify specific items, but may describe the collateral by type.
- Prepare and file a financing statement correctly identifying the debtor, the collateral and the secured party. The financing statements need to be filed in the proper office. This can be done online in a large number of states.
- Identify which goods are subject to a perfected PMSI (i.e., all the criteria for claiming a PMSI have been met)
- Create a tickler system to remind yourself of (i) expiration of the financing statement 5 years from filing, in order to continue financing statements, and (ii) expiration of 5-year notice period for purchase money security interests.
- Analyze when your products will be incorporated into other products to contemplate conflicts with other lienholders. You may want to consider intercreditor agreements.
- Analyze how the debtor's credit practices will affect your collateral. Your lien will continue in chattel paper in identifiable cash proceeds, but not in any accounts receivable. Does the debtor generate accounts receivable? Can a mechanism be created to segregate cash proceeds so that they are identifiable as proceeds for the sale of your inventory?
- If a bankruptcy case is filed and you are a secured creditor, make sure your rights as a secured creditor are respected (e.g., that if your collateral is to be sold, you either get paid or get a replacement lien on something).

**For Suppliers from whom you are buying:**

- Examine contracts related to acquisition of goods.  Is there sufficient identification of the goods in the contract? Would a third party reasonably conclude from the seller's records that the goods had been identified to your contract?  If there is insufficient identification of the goods, then you need to create some identification of those goods to the relevant contract, so that when you pay the final amount due under the contract you are entitled to receive goods free and clean of any lien.
- Do a UCC search on your supplier to determine if there are any liens on inventory.
- If goods are located with third parties, such as for repair or processing, consider filing an informational financing statement describing a bailment arrangement.

***Note:*** All references to provisions of the UCC are to the Uniform Commercial Code as in effect in the State of Indiana on the issue date of this Alert.

Readers are advised to contact legal counsel to determine how these concepts may apply to their specific situations.  At Krieg DeVault LLP, please contact the chair of our Creditors' Rights & Bankruptcy Practice, **C. Daniel Motsinger** or one of our senior business attorneys, **Robert A. Greising**.

*Disclaimer: This Alert does not address all risk issues to be considered, such as internal governance issues often linked to the so-called "zone of insolvency" phase of financial struggles and the response of a company's board and management to those circumstances, nor the complexities of an insolvency process should a relevant entity be in bankruptcy or similar proceedings.  We also provide this for informational purposes and not as legal advice for any particular situation.*