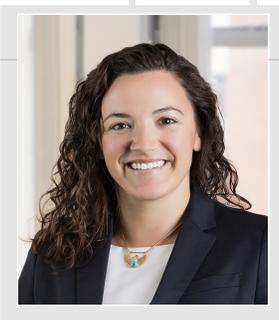


## Trading Up: Improving the Trade Creditor's Lot Vis-à-Vis the Secured Lender



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A seller of goods who enjoys a casual relationship with a buyer — without adhering to strict documentation and enforcement standards — can find itself in dire straits in the event of that buyer's insolvency. Many sellers operate without agreements and rely on purchase orders and invoices to document their customer relationships, and may also fail to investigate potential security interests that might prime those sellers' interests in delivered goods come the buyer's insolvency. When such a seller seeks to reclaim delivered goods, it will often learn promptly from the customer's secured lender that the seller is “out of luck” because its claim to delivered goods is junior to the secured lender's interest in those goods. Consequently, that seller involuntarily becomes a “trade creditor” of the buyer.

Article 2 of the Uniform Commercial Code (UCC) governs the sale of goods, and Article 9 governs, *inter alia*, transactions intended to create security interests in personal property or fixtures, including goods, as well as security interests arising under Article 2. [1] Every state other than Louisiana has adopted some form of Article 2, and all states have adopted some form of Article 9. In most cases, the adopted versions are substantially identical to the corresponding UCC provisions. [2]

UCC § 2-702(2) provides, in pertinent part, that “[w]here the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt...” [3] To the extent a reclamation right exists under state law, [4] § 546(c)(1) of the Bankruptcy Code extends the 10-day reclamation period to “45 days after the date of receipt of such goods by the debtor; or ... 20 days after the date of commencement of the case, if the 45-day period expires after the commencement of the case.” [5]

By subjecting sellers' rights under subsection (2) to those of a “good faith purchaser under this Article [2]...,” [6] however, UCC § 2-702(3) may dash unprepared sellers' hopes. The UCC treats secured parties as “good faith purchasers,” [7] thus affording the rights of secured parties higher priority than those of a reclaiming seller in a buyer-borrower's inventory. [8] And once the buyer-borrower has filed for bankruptcy, the Bankruptcy Code makes clear that a seller's reclamation rights are “subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof....” [9]

The good news is that even if sellers decide to offer buyers the convenience of unsecured trade terms, sellers' rights to goods sold are not necessarily relegated to those of the buyer's secured lender — so long as they follow four straightforward steps.

*First*, the seller should run a search for any financing statements filed with the Secretary of State where the buyer is located. [10] This will alert the seller to asserted security interests in the buyer's inventory, which would include the seller's goods.

*Second*, the seller should document its agreement with the buyer and expressly reserve title to the goods sold until the seller receives payment therefor. Under the UCC, a seller's reservation of title is treated as a security interest under Article 9. [11] Absent a reservation of title, the seller will be treated as an unsecured creditor. [12]

*Third*, the seller must perfect its deemed security interest in the goods sold pursuant to its agreement. [13] Under Article 9, the general rule is security interest in goods is perfected by filing a financing statement with the Secretary of State where the debtor is located. [14] This gives the seller's security interest in the goods priority over unperfected security interests, [15] as well as over subsequently perfected security interests in those goods.

*Fourth*, to protect its perfected security interest in the goods sold as against *prior* perfected security interests (like the security interest of the buyer's secured lender — if any — in the buyer's inventory), the seller must satisfy four additional requirements. [17] *First*, a security interest arising under UCC § 2-401 (a purchase-money security interest, or a "PMSI" [18]) must be perfected when the buyer receives possession of the inventory. [19] In other words, the financing statement must have been filed before the possession transition takes place. *Second*, the seller must send an "authenticated notification" to the buyer's secured lender. [20] To "authenticate" a notification means to sign, and may encompass signing by electronic signature, though it is not clear that a simple e-mail is sufficient. [21] *Third*, the secured lender must receive the notification within five years before the buyer-debtor receives possession of the goods. [22] This means that once the secured lender receives this authenticated notification (and the seller should ensure proof of receipt), the seller can shield goods shipped under its agreement with the buyer from the attachment of the secured lender's security interests for the next five years. And *finally*, the notification must state that the seller has a PMSI in the goods sold and describe those goods. [23]

The prepared seller — with a trade agreement reserving title to goods sold in hand — having filed a financing statement with the Secretary of State in which the buyer is located describing the goods to be sold pursuant to that agreement, and having completed the steps prescribed by U.C.C. § 9-324(b), including the provision of an authenticated notification to the buyer's secured lender, will enjoy the right to (among other remedies afforded under the UCC) reclaim its goods upon learning of its customer's insolvency, thereby avoiding the plight of being an unsecured trade creditor in the buyer's bankruptcy.

The seller should know, however, that the protection of its interests in goods sold against the attachment of a secured party's security interest could come at a cost to the buyer, and such cost might be significant in the course of the seller's business dealings with its customer. When the buyer's secured lender receives notification that the seller will be preventing its goods from entering the pool of inventory securing the buyer's line of credit, that secured lender may make a corresponding adjustment to the amount of credit it is willing to extend to the buyer. This, of course, will turn on the secured lender's ability to limit funds advanced under the applicable debt documents, but the seller that wants to balance its own financial security against its customer's willingness to do business should consider this implication.

[1] U.C.C. §§ 2-102, 9-109(a)(1), (5).

[2] This article will provide citations to UCC provisions in lieu of referring to each state's implementation thereof.

[3] U.C.C. § 2-702(2).

[4] See, e.g., *In re Coast Trading Co. Inc.*, 744 F.2d 686, 692 (9th Cir. 1984) ("Section 546(c) does not create a substantive right to reclamation. It allows a seller to reclaim goods only to the extent there is a statutory or common law right to do so.").

[5] See 11 U.S.C. § 546(c)(1).

[6] U.C.C. § 2-702(3).

[7] See U.C.C. § 1-201(b)(29) (defining "purchase" to include "taking by ... pledge, lien, ... or any other voluntary transaction creating an interest in property"), (30) (defining "purchaser" as "a person who takes by purchase"), (20) (defining "good faith" as "honesty in fact and the observance reasonably commercial standards of fair dealing.").

[8] The vast majority of states that have interpreted their own implementations of these UCC provisions concur, though to differing degrees on the effect of such "subjection." See Keith M. Baker, "Reclamation: An Uncertain Remedy," *ABI Journal* (July 1, 2000) (discussing the split into three lines of authority as to the effect of the words "subject to").

[9] See 11 U.S.C. § 546(c)(1); see also, *inter alia*, *Matter of Reliable Drug Stores Inc.*, 70 F.3d 948, 950 (7th Cir. 1995); *In re Coast Trading Co.*, 744 F.2d 686, 690 (9th Cir. 1984).

[10] See U.C.C. §§ 9-301(a), 9-501(a)(2).

U.C.C. §§ 2-401 ("Any retention or reservation by the seller of the title (property) in goods shipped or delivered to the buyer is limited in effect to a reservation of a security interest."); § 1-201(35) ("The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer under Section 2-401 is limited in effect to a reservation of a 'security interest.'").

[12] See, e.g., *In re J. Adrian Sons Inc.*, 205 B.R. 24, 27 (Bankr. W.D.N.Y. 1997) (finding that absent documentation of the seller's retention of title in the goods sold, seller "is left without even a vestige of a claim of a security interest in the equipment (there having been no security agreement executed, and no retention of title)").

[13] Until the buyer obtains possession of the goods, no filing is necessary to perfect a seller's Article 2 security interest. See U.C.C. §§ 9-110, 9-309(6). But once a debtor obtains possession of the goods sold, the ordinary rules of perfection and priority under Article 9 apply. See *id.* This makes sense, given the seller's right under U.C.C. § 2-705 to stop goods while they are "in transit" — that is, until delivery has been made and the buyer obtains possession of the goods.

[14] See U.C.C. §§ 9-310(a), 9-301(a), 9-501(a)(2).

[15] See U.C.C. § 9-322(a)(2).

[16] See U.C.C. § 9-322(a)(1).

[17] See U.C.C. § 9-324(b).

[18] See U.C.C. § 9-103(a), (b).

[19] U.C.C. § 9-324(b)(1).

[20] U.C.C. § 9-324(b)(2).

[21] See U.C.C. § 9-102(a)(7), U.C.C. § 9-102 cmt. 9.

[22] U.C.C. § 9-324(b)(3).

[23] U.C.C. § 9-324(b)(4).

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