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Secured Financing of Inventory: Revolving Credit, UCC Perfection, Proceeds, Competing Liens

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Secured Financing of Inventory

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Outline

- Meaning of ‘inventory’
- Application of Article 9 to inventory transactions
- Creation
- Perfection
- Priorities
- PMSIs and consignments
- Proceeds
- Competing Liens
- Lending Formula (‘Borrowing Base’)

➤ Meaning of 'inventory' (§ 9-102(a)(48))

- 'Goods'
- Held for:
 - o Sale
 - o Lease
- Leased
- Raw materials, WIP used or consumed in a business



Does Article 9 apply to the Inventory transaction?

- ‘Security interest’ in inventory to secure an obligation
 - ‘Dirty’ leases
- Does not apply to sales of inventory
- Consignments




Consignments (§ 9-109(a)(4))

- Consignment creates a ‘security interest’
(§ 1-201(b)(35))
- Consignor is ‘secured party’
(§ 9-102(a)(74))
- Consignee is ‘debtor’
(§ 9-102(a)(28))

Attachment (§ 9-203)

- The usual rules
 - o Security agreement (§ 9-203(b)(3))
 - o Rights in the collateral (§ 9-203(B)(2))
 - o Give value (§ 9-203(b)(1))




Security agreement – special issues (§ 9-203(b)(3))

- Description of ‘inventory’
- After-acquired inventory
- How to apply to:
 - o ‘Dirty’ leases
 - o Consignments



Security agreement

- ‘Grant’ of security interest
(§ 9-203(b)(3)(A))
- Consignment or sales language
‘creates or provides’ for ‘security
interest’ in consignment and sales
transactions



Rights in the collateral or power to transfer (§ 9-203(b)(2))

- ‘Power’ to transfer
 - o Consignee
- Non-transferable property




Limitations on transferability of collateral

- IP and IP licenses
 - o Trademarks
 - o Patents
 - o Copyrights

Give value (§ 9-203(b)(1))

- Meaning of ‘value’ (§ 1-204; NY § 1-201(44))
 - o ‘Any consideration sufficient to support a simple contract’
 - o Commitment to make a loan
- To whom?
 - o OK if value goes to third party, e.g., when security interest granted by guarantor and loan made to borrower



Proceeds (§ 9-102(a)(64))

- Security interest in proceeds automatically attaches if security interest has attached to original collateral (§ 9-203(f))
- Security interest may ‘detach’ after 20 days if certain requirements are not met (§ 9-315)
- Priority addressed below



Revolvers and after-acquired collateral

- Generally allowed (§ 9-204(a))
- In security agreement should refer to ‘after-acquired’ collateral or the like (§ 9-108, Comment 3)



Revolvers and future advances

- Security interest may secure future advances (§ 9-204(c))



Financing statement

- Generally available for inventory



Financing statement – where to file

- File at location of debtor (§ 9-301(1))
 - o *Not* location of inventory




What is the ‘location’ of the debtor?

- ‘Location’ of debtor:
 - o Registered organization (corporation, LLC, LP): state of organization (§ 9-307(e))
 - Rules for certain business trusts
 - o Partnership: state of chief executive office (§ 9-307(b)(3))
 - o Individual: state of principal residence (§ 9-307(b)(1))
 - o Non-US entity: country of chief executive office, *if* country has filing system for the collateral (§ 9-307(c))



Financing statement – content (§ 9-502(a))

- Debtor name
- Secured party name
- ‘Indication’ of collateral



Financing statement – debtor name (§ 9-503)

- Must be exactly correct
- For registered organization: copy exactly from organizational documents
- Individuals
 - o What is the ‘name’?
 - o New rules discussed below

Financing statement – examples of mistakes

Debtor name	Mistaken name on financing statement
C. W. Mining Company	CW Mining Company
EDM Corporation	EDM Corporation dba Equipment
Michael Erwin	Mike Erwin
Terrance Joseph Kinderknecht	Terry J. Kinderknecht
Rodger House	Roger House
Michael Barry	Mike Barry
Andrew Fuell	Andrew Fuel
Silver Dollar LLC	Silver Dollar Stores LLC
Jim Ross Tires, Inc.	Jim Ross Tire Inc.
D Dennis Preston	D.Dennis Preston



Financing statement: individual's name

- Alternative A (waterfall) or Alternative B (safe harbor):
 - o Driver's license (or other state ID from same office) from state of filing
 - o 'Name'
 - o First personal name and surname
- No guidance on what is 'first personal name' and 'surname'

Financing statement – secured party's name

- OK to name 'representative' of secured party (§ 9-502(a)(2))
 - Do not have to indicate representative status (§ 9-503(d))
- Less stringent rules as to getting secured party's name exactly right (§ 9-506, Comment 2)



Financing statement – 'indication' of collateral

- OK if would satisfy security agreement (§ 9-504(1))
- Refer to 'after-acquired' inventory?
- May use 'all assets' as 'indication' (§ 9-504(a)(2))



Financing statement – post-closing events

- Change in debtor's name (§ 9-507(c))
- Debtor becomes located in different jurisdiction (§ 9-316(a)(2))
- Collateral transferred to a different debtor
 - o Same jurisdiction (§§ 9-315(a)(1) & 9-507(a))
 - o Different jurisdiction (§ 9-316(a)(3))
- Some changes in recent amendments



Financing statement – amendments

- Change name
- Change collateral
- Change other information
- Assign
- Terminate

➤ Possession (§ 9-313)

- Applies to inventory
- Through agent is OK (§ 9-313, Comment 3)
- Bailee (§ 9-313(c))
 - o Not effective unless bailee authenticates record (§ 9-102(a)(69)) that it has possession for ‘benefit of’ secured party
 - o Bailee may not be too ‘closely connected’ to debtor (§ 9-313, Comment 4)



Compliance with other laws (§ 9-311)

- **Motor Vehicles / Certificate of title** (§ 9-311(a)(2))
 - File financing statement for dealers with respect to inventory (seller or lessor of cars) (§ 9-311(d))
 - File financing statement if car dealer not in the business of selling cars (as well as leasing, if leasing is what it does) (§ 9-311(d))
- **Airplanes** (§ 9-311(a)(1))
 - FAA filing
 - UCC still applies to non-perfection issues
 - Capetown Convention
- **Ships**



Proceeds

- Perfected if security interest in original collateral was perfected (§ 9-315(c))
- May lose perfection after 20 days if certain requirements are not met (§ 9-315(d))
- Priority issues discussed below



Perfection by possession

- First to ‘perfect’ if both secured parties perfected by possession (§ 9-322(a)(1))
- This means that possession without attachment is not sufficient to set priority because ‘perfection’ has not occurred yet




Priority: other secured creditors

- General rule, first to file or perfect (§ 9-322(a)(1))
- Exceptions below!




Other priority issues

- Purchase-money security interests
 - o Consignments
- Proceeds
 - o Accounts
 - o Chattel paper (§ 9-330(b) & (c))
 - o Deposit accounts (§ 9-327(1))



Purchase-money security interests (§ 9-324)

- Goods only (§ 9-103(a)(1))
- Inventory
 - Notice to earlier secured party before deliver (§ 9-324(b))
 - File before deliver (§ 9-324(b)(1))
- Related software
- Application to consignments



Priority in proceeds (§ 9-322(b)–e))

- Generally follow priority of original collateral
- Special rules for non-temporal priority (§ 9-322(c))



Priority in proceeds – accounts (proceeds of inventory)

- Secured party with security interest only in ‘inventory’ junior as to proceeds that are accounts to another secured party that earlier filed as to ‘accounts’
- Secured party with security interest only in ‘inventory’ senior as to proceeds that are accounts to another secured party that later filed as to accounts



Purchaser of chattel paper (proceeds of inventory) (UCC § 9-330 (b) and (c))

- Purchaser of chattel paper can have priority over inventory secured party



Proceeds into deposit account

- Even if secured party with perfected security interest in inventory can trace proceeds through accounts into deposit account and is perfected in deposit account (by filing or control), may lose to transferee from deposit account (UCC § 9-332(b))



Certain transferees against perfected secured party

- ‘Buyer in ordinary course of business’ takes free of earlier perfected security interest (§§ 9-320 & 1-201(b)(9))
- ‘Lessee in ordinary course of business’ takes free of earlier perfected security interest (§ 9-321(c))



Competing liens: overview

Potential third party claims:

- Landlords
- Warehouseman/bailees
- Processors
- Inventory financiers
- Consignors/consignees



Competing liens: overview

Competing liens arise because the inventory is:

- stored on leased premises
- stored in a warehouse owned by a third party
- located with a third party for modification or improvement
- Financed by a third party
- consigned (either to or by the borrower)



Landlord liens

- **Issue:** Landlord's lien on personal property on leased premises
- **Basis for lien:**
 - o *Statute:* State-specific as to (a) existence, (b) when lien arises, (c) priority, and (d) necessary steps
 - o *Common Law:* Also state-specific
 - o *Contract:* Granted in lease; landlord may need to file a financing statement



Landlord liens

- **Solution:** Landlord Agreement
- **Key Provisions:**
 - *Superiority of lender's lien*
 - Acknowledgment of lender's lien
 - Waiver/subordination of landlord's lien
 - Fixtures
 - *Notices and Cure Provisions*
 - *Access and Use of Premises*
 - Access to and ability to use/occupy premises
 - Obligation to pay "rent" during such period
 - Permitted activities (e.g., store and sell collateral)



Warehouse liens

- **Issue:** Similar to landlord lien – bailee has lien on goods in its possession
- **Basis for Lien:**
 - o *Statute* (§ 7-209): Grants lien to bailee to secure payment of charges related to storage, transportation, insurance and labor
 - o *Contract*: Review standard terms of contract which are sometimes incorporated by reference



Warehouse liens

- **Solution:** Bailee agreement
- **Key Provisions:**
 - o *Acknowledgments*
 - Acknowledgment of lender's lien
 - Bailee holds goods for lender's benefit
 - o *Bailee Reps and Warranties*
 - Bailee is not a consignee
 - Bailee has no ownership interest
 - Bailee will not issue negotiable receipts
 - Goods are to remain separately identifiable



Warehouse liens

- **Key provisions (continued):**
 - *Lender's Rights and Obligations*
 - Upon notice, bailee will no longer deliver goods except as directed by lender
 - Lender has right to inspect and remove goods
 - Authorization to file UCC financing statement
 - *Liens and Charges*
 - Borrower should always remain liable
 - Seek subordination (but bailee may not agree)
 - Lender can limit by dollar amount/time frame, and impose a reserve
 - Lender should require advance notice and right to cure before bailee takes any action



Processor liens

- **Issue:** Processor receives goods for improvement/repair and has a lien on the goods to secure charges
- **Basis for lien:**
 - o *Statute:* State-specific as to (a) existence, (b) when lien arises, (c) scope of lien and (d) priority
 - Statute may also differentiate among types of assets
 - o *Common law:* Also state-specific



Processor liens

- **Solution:** Processor Agreement
- **Key Provisions:**
 - o Acknowledgment of lender's lien
 - o Subordination of processor's lien
 - o Goods are to remain separate from other goods
 - o Processor disclaims ownership
 - o Processor will not foreclose on any lien
 - o Permit lender to inspect and remove collateral



Processor liens

- **Additional Issue:**
 - o The processor may:
 - Combine the goods with the processor's goods and/or
 - Sell the goods on behalf of the borrower
 - o This could change how the transaction is characterized:
 - Secured transaction?
 - Sale of goods in ordinary course of business?



Consignments

- Consignments (UCC § 9-102) include any transaction, that involves delivery of goods to a merchant for purposes of sale and for which:
 - o the merchant (a) deals in goods of that kind under a name other than the name of the person making the delivery, (b) is not an auctioneer, (c) is not generally known by its creditors to be substantially engaged in the selling of goods of others;
 - o the aggregate value of each delivery of goods exceeds \$1,000;
 - o the goods are *not* consumer goods immediately before delivery;
and
 - o the transaction does not create a security interest that secures an obligation (NOTE: This requires review of the underlying arrangement)



Consignments

- If a consignment exists, then borrower (consignor) must comply with rules applicable to a purchase money security interest (§ 9-324)
- If borrower does not, then the goods in the consignee's possession are subject to the lien of the consignee's lender



Consignments

- Steps that borrower must take:
 - *File a UCC financing statement*
 - *Send written notice of security interest to all third parties that hold a conflicting security interest in the goods (i.e., the consignee's secured creditors)*
 - Notice (a) states that borrower has or expects to acquire a purchase money security interest in inventory and (b) describes the inventory placed on consignment
 - Notice is received within five years **before** the consignee receives the inventory



Consignments

- Notice is effective for 5 years
- Needs to be 'refreshed' if consignee's secured creditors would otherwise win under 'first to file' rule



Lending considerations

- Lending formula (aka ‘Borrowing Base’)
 - o Percentage of the lower of cost (FIFO) and market value of *eligible* inventory
 - o Distinguish formula from collateral



Borrowing base

- Eligibility
 - o Finished goods v. WIP
 - o Spare parts / packaging materials
 - o Special order goods
 - o Quality (not damaged, slow moving or obsolete)
 - o Dated inventory
 - o Inventory within the US



Borrowing base

- Eligibility (continued)
 - First priority lien
 - competing liens (landlords, bailees, processors, etc.)
 - Need agreement with 3rd party
 - Consigned inventory
 - Need to treat like PMSI
 - Taxes (sales / income / other)
 - Bill and hold
 - License restrictions



Borrowing base

- Reserves
 - o Mandatory reserves
 - o Discretionary reserves