Protection for the prepaying purchaser

What if the seller goes broke?

By Brian D. Hulse

A town wants to prepay for a fire truck. But what if the manufacturer is in shaky financial shape?

When the typical consumer or business person buys a product from a store or supplier in a cash or credit transaction, he or she does not stop to think about whether it may be subject to a security interest. That rarely causes a problem because the law generally protects a buyer who pays for goods at or after delivery. However, where the buyer prepays, the seller's bankruptcy prior to delivery can cost the buyer its prepayment and leave it with no right to the goods.

Fortunately, there are steps a prepaying commercial buyer can take to avoid ending up in this situation. Buyers in consumer transactions have better statutory rights than commercial buyers and this article does *not* deal with consumer buyers.

The critical things a *commercial* buyer can do where there is a risk of the seller's insolvency before delivery are to take a security interest in the goods it is buying and to get a subordination agreement from any other creditor holding a conflicting security interest. Alternatively, a buyer of a major custom-manufactured product can require the seller to provide it with performance and payment bonds; however, such bonds are not appropriate for many types of transactions, they are expensive and many sellers cannot get them.

As the many reported cases in this area show, buyers often fail to take appropriate precautions and wind up holding the bag.

UCC rights and remedies — The Uniform Commercial Code's Article 2 (which deals with sales of goods) gives the buyer a variety of statutory rights and remedies when the seller breaches the purchase contract, even if the buyer does not have a security interest. The full array of Article 2 remedies is set out in great detail in Parts 6 and 7 of Article 2. The most important ones involve getting possession of the goods or recovering damages. However, if the seller is insolvent, an unsecured buyer's statutory remedies become extremely limited. In that situation, it is crucial for the buyer to have a senior security interest under UCC Article 9 in the goods it is buying and in related items such as plans, components acquired for incorporation into the goods, etc.

If the seller becomes insolvent, the buyer's rights and remedies collide with those of the seller's other creditors. The seller will usually be financed by a bank or other lender with a security interest in all of its assets including the goods being bought by the buyer. If the seller goes broke, both the buyer and the secured lender will want to claim the goods. Absent appropriate precautions by the buyer, the deck is heavily stacked in favor of the secured creditor.

The primary statutory protection provided to the buyer is §9-320 (all statutory citations are to the official text of the UCC). It provides that "… a buyer in ordinary course of business … takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence." On casual reading, §9-320 seems to protect the buyer; however, it has very serious limitations. A full review of those limitations is beyond the scope of this article, but there is a general discussion of the subject in 4 White and Summers, *Uniform Commercial Code* §33-8 (5th ed. 2002) (White & Summers).

Hulse is a shareholder with Heller Ehrman White & McAuliffe LLP, in Seattle. His e-mail is bhulse@hewm.com.

Limitations of statutory rights and remedies — One key limitation is that a commercial buyer does not have the protection of §9-320 unless it comes within the detailed definition of a "buyer in ordinary course of business" set out in §1-201. The core requirement for buyer in ordinary course of business status is that the buyer be:

> … a person that buys goods in good faith, without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind.

Many commercial buyers could meet that part of the test. However, when Article 9 was overhauled several years ago (with an effective date of July 1, 2001 in most states), a change was also made in §1-201's buyer-in-ordinary-course-of-business definition. That change added a new and important limitation on the buyer's rights by providing that: "Only a buyer that takes possession of the goods or has a right to recover the goods from the seller under Article 2 may be a buyer in ordinary course of business."

With this change, absent a valid senior security interest in the goods, a buyer must analyze its right to recover the goods under Article 2 to determine whether it is entitled to the protection of §9-320. It will us
ually be disappointed.

The Article 2 provisions are complex, but some of the key ones are:

- Section 2-716, which provides that a buyer has a right of replevin if it holds a "special property interest" in the goods. That section also provides for specific performance of the seller's obligations. However, each of those remedies is available only in limited circumstances.
- Section 2-501, which provides for how the buyer obtains a "special property interest."
- Section 2-502, which severely limits the buyer's right of recovery by providing that, if the seller is insolvent, the buyer can recover the goods *only if the seller becomes insolvent within 10 days after receipt of the first installment of their price*. Obviously, that will be very rare and is difficult to prove.

In the great majority of cases, the buyer's Article 2 remedies against an insolvent seller will be inadequate and, if it does not also have a senior Article 9 security interest or a performance and payment bond, the buyer will lose out to the seller's secured lender.

The buyer will lose out to seller's secured lender.

Illustrative cases — There are many reported cases on the relative rights of the buyer and the secured lender under the predecessor to §9-320 contained in the old version of Article 9. A brief discussion of two of the cases will highlight some of the problems with an unsecured buyer's statutory remedies.

In *In re Tacoma Boatbuilding Co.*, 158 B.R. 19 (Bankr. S.D.N.Y. 1993), the buyer entered into contracts with a shipyard to construct two vessels for a price of more than $31 million each. The vessels and the contracts for their construction were substantially identical except for different delivery dates. The shipyard had previously granted a security interest in its inventory to a group of banks. When the buyer entered into the contracts, it was unaware of the banks' security interest.

During construction of the vessels, the shipyard suffered severe financial difficulties and stopped construction. Shortly thereafter, the shipyard filed for bankruptcy. At that point, one of the vessels was essentially complete and ready for delivery. The other was about 85 percent complete, and the buyer had paid virtually the entire price of both vessels. The vessels were sold out of the bankruptcy for a fraction of the contract price and both the banks and the buyer's successor-in-interest claimed they were entitled to receive the proceeds. Interestingly, the court reached different results with respect to the two vessels.

As to the completed vessel, the court held that the buyer was a buyer in ordinary course of business protected by the predecessor to §9-320 because:

- when the vessel became deliverable, the banks' security agreement permitted the sale and the buyer was unaware of a violation of the security agreement;
- the Coast Guard had issued a certificate of documentation showing the buyer as the owner;
- the shipyard had issued a builder's certification of completion; and
- the vessel had been "identified to the contract" under §2-501.

With respect to the second vessel, the court focused on the fact that it was not finished and held that, in order to constitute "goods," an item must be complete. It concluded that only a buyer of "goods" is entitled to buyer-in-ordinary-course-of-business status and, therefore, held that the banks' security interest in the incomplete vessel trumped the claims of the

buyer and awarded the proceeds of its sale to the banks. Other cases have reached differing conclusions on the issue of whether incomplete items can qualify as "goods" for purposes of identification to a contract. *See*, 2 Hawkland, *UCC Series* §2-501:2 (2002).

The *Tacoma Boatbuilding* court discussed the terms of the contract specifying when title to the vessels was to transfer to the buyer, but appropriately held that passage of title was immaterial to the issue of buyer-in-ordinary-course-of-business status. Section 9202 generally makes the location of title irrelevant for purposes of Article 9 and §1-201(35) provides that a purported reservation of title is effective only to create a security interest, which must then be perfected in accordance with Article 9. Nevertheless, some courts have considered the passage of title to be an important, if not critical, factor in the analysis. *See*, White & Summers at §33-8, fn. 5.

Another illustrative case is *In re G. Paoletti Inc.*, 205 B.R. 251 (Bankr. N.D. Cal. 1997), which involved a contract under which the city of Oakland agreed to buy two custom-built fire trucks for approximately $360,000. When the seller filed for bankruptcy, the buyer had paid approximately half the purchase price and the trucks were about 75 percent complete. The evidence introduced by the buyer indicated that the value of the incomplete trucks was approximately $310,000 and that it would cost roughly $140,000 to complete them.

The seller's trustee in bankruptcy sought court authority to sell the incomplete trucks for $125,000 to a third party free and clear of all liens and interests. Both the buyer and the seller's secured lender made claims to the trucks or their proceeds. Ultimately, the court authorized the sale free and clear and awarded the proceeds to the lender.

Unlike the *Tacoma Boatbuilding* court, the *Paoletti* court stated that goods can be identified to a contract even though they are not complete. However, it also held that where the seller becomes insolvent before delivery, §2-502 provides the buyer's *sole* remedy for obtaining possession of the goods and that the replevin provisions of §2-716 are not available. As noted above, one of the requirements of §2-502 is that the seller *become* insolvent *within 10 days* after receipt of the *first* installment of the purchase price. That requirement obviously makes the remedy of little practical value in most cases.

These cases highlight the inadequacy of the UCC's statutory remedies for an unsecured buyer and the need for it to take further precautions.

How can the buyer best protect itself? — What should the prepaying buyer do to protect itself? The critical steps are:

- obtain and perfect an appropriate Article 9 security interest;
- get lien searches against the seller to identify any conflicting security interests; and
- establish the priority of the buyer's security interest by getting subordination agreements and consents to the sale from the holders of conflicting security interests.

While these precautions are not necessary (or likely to be agreed to) when the seller is highly credit-worthy, if there is a risk of the seller becoming insolvent, they are critical.

The buyer's security interest should secure all the seller's obligations to the buyer under the purchase contract and any related agreements. It should cover, at a minimum, the goods to be purchased and all materials, component parts and accessories acquired by the seller to incorporate into those goods. Depending on the nature of the contract and the goods, it may also be appropriate to cover plans and specifications, relevant contracts with third parties, specialized tooling and other items related to the goods.

The seller's secured lender is likely to be willing to enter into an appropriate subordination agreement if that is a condition to the purchase contract because it will want to see the buyer enter into a profitable contract. Depending on the seller's financial position, the lender may require that the buyer make its payments directly to the lender or otherwise take control of those payments.

Even if the lender will not agree to subordinate, the buyer may be able to get priority over the lender's security interest by following §9-324's provisions allowing a purchase money security interest to take priority over a preexisting nonpurchase money security interest. However, it would be risky for the buyer to rely solely on those provisions in most cases.

There are various other issues the buyer may need to consider depending on the nature of the contract, the type of goods being purchased and the financial position of the seller.

First, the buyer should address insurance coverage. The seller's lender will undoubtedly require the seller to carry adequate insurance on its inventory and other assets and to name the lender as loss payee under a lender's loss-payable endorsement. The subordination agreement should make it clear that the buyer's priority extends to proceeds of the collateral including insurance proceeds.

The buyer should require the seller to maintain adequate insurance during the manufacturing process. For some major custom-manufactured goods, it may be appropriate to require that insurance be provided under a separate policy. The buyer should be named as loss payee with respect to the goods, ideally under a lender's loss-payable endorsement recognizing its interest as a secured creditor under the security agreement. A lender's loss-payable endorsement protects against actions of the seller that could otherwise void coverage, such as misrepresentations in the insurance application. For any major contract, the buyer should seek the advice of an experienced insurance broker.

Second, if the contract is for a vessel, aircraft, titled vehicle or other item subject to titling with a government agency, the buyer may want to require the seller to title it in the name of the buyer at the earliest possible time, or at least not permit the seller to title the item in its own name. If the seller titles the item in its own name, the buyer is likely to lose perfection of its security interest unless it complies with the perfection requirements of the applicable title statute. *See*, §§9-109(c)(1) and 9-337.

Third, if the buyer is providing the seller with any specialized tooling, plans, major components of the goods or other significant items already owed by the buyer, the contract should make it clear that those items remain the property of the buyer and the buyer should file a UCC financing statement saying so.

Finally, the buyer should remember that, to the extent the seller is itself a prepaying buyer with respect to major components of the goods, the concerns raised in this article also apply to the contracts between the seller and the suppliers of those components. If a significant amount of the buyer's prepayment is being used to prepay the seller's suppliers, the buyer may need to make sure that the seller appropriately protects its rights against those suppliers.

Although there are serious risks to entering into a contract to purchase goods from a seller whose solvency is questionable, there are some basic steps a prudent buyer can and should take to protect its rights. The buyer generally must take those steps ***before*** entering into the contract. Later on, when a problem develops, it is likely to be too late. *blt*