REDUCING THE RISKS OF DEFAULTING EQUIPMENT BUYERS

by H. Lee Schwartzberg, Jr., Esq.
© 2005

The Risk

The commercial realities of the marketplace frequently require manufacturers to offer payment terms to their customers and dealers, but simply accepting an unsecured promise to pay for valuable equipment creates a substantial risk. You may have experienced the unfortunate situation where one of your customers or dealers fails to pay for expensive equipment, and yet you were unable to retrieve it or, worse yet, the equipment was taken by one of your buyer’s other creditors.

The purpose of this article is to explain one approach you can take to minimize this risk.

Treat a Loan Like a Loan

Commercial lenders typically seek collateral for their loans. When you deliver your equipment to a buyer without receiving payment, make no mistake, you are extending credit. While you may expect the debt to be outstanding for a short period of time, the risk to which you expose yourself is really no different than the risk taken by a commercial lender when it finances your customer’s purchase of the equipment, and you should protect yourself accordingly.

Although you should certainly take the appropriate steps to evaluate the creditworthiness of your buyers, that process is beyond the scope of this article. Similarly, we will not consider credit insurance programs or the factoring of receivables.

This article will focus on securing your buyer’s debts to you by obtaining a lien on the equipment you sell.

The Basics of Article 9

The statutory scheme adopted in the United States and most of its territories for establishing a lien on collateral (other than real property) is found in Article 9 of the Uniform Commercial Code (“Article 9”).

The purpose of Article 9 is to provide “a comprehensive scheme for the regulation of security interests in personal property and fixtures.”

While there are some variations from state to state, each of the 50 states has adopted some version of Article 9, which most recently underwent substantial revisions that became effective as of July 1, 2001. With certain exceptions such as mechanics’ liens, Article 9 applies to all transactions, regardless of form, that create a security interest in personal property or fixtures. Many “leases,” or arrangements where a seller attempts to retain title to protect its right to payment (a practice common in Europe), are actually secured transactions and will be analyzed by the courts as such. Simply characterizing a secured

---

1 Official comment 1 to UCC §9-101
2 UCC §9-109(a)(1)
transaction as something else will not keep it from being measured against the requirements of Article 9.

At its most fundamental level, establishing your right to collateral involves (i) creating a lien on the collateral, (ii) “perfecting” the lien and (iii) making sure that your right to the collateral has “priority” over the rights of other perfected secured creditors. Only when you have the legal right to the collateral can you repossess and sell it.

**The Security Agreement**

To become a “secured party” able to enforce your rights in the collateral against the buyer (typically referred to as the “debtor”), you must make sure that the debtor “authenticates,” or signs, a security agreement. A security agreement can be a stand-alone document, or it can be part of another agreement, such as a form of distribution agreement you may use for your dealers. It is critical that the security agreement accurately describe the collateral. Your lawyer will describe in the security agreement not only the collateral your buyer has at the point in time the security agreement is signed, but also (i) collateral the buyer will obtain from you later, commonly known as “after acquired property,” and (ii) the “proceeds” of your collateral, i.e., what is obtained upon the collateral’s sale or other disposition.

**Perfection**

To insure you can enforce your security interest not only against your buyer, but against other creditors of your buyer as well, your security interest must be “perfected.” Typically, this is accomplished by filing a UCC-1 “financing statement” in the state where your debtor is incorporated or otherwise organized. The financing statement puts the world on notice that you have a lien.

It is important to note that if you sell items, such as trucks, boats or farm tractors that are covered by certificates of title directly to end users rather than to dealers, the method of perfecting the lien is usually by noting the lien on the certificate of title, and not the filing of a UCC-1.

**Priority**

A buyer that has failed to pay you is probably also having problems with its other creditors. That is why it is critical to insure that your claim to the collateral has “priority” over the claims of other secured creditors. Generally, the first creditor to obtain a perfected lien will be the first in line to get paid when the collateral is sold. However, Article 9 provides a special status for those sellers providing financing for their goods, called “purchase money financing,” in recognition of the benefit of this practice to our economy. Article 9 can give those sellers who have followed the steps to obtain a perfected purchase money security interest “priority” over the

---

3 UCC §9-203(b)(3)(A)
4 UCC §9-102(a)(64)
5 UCC §9-303(c) and §9-311(d)
claims of other creditors having security interests in the same collateral with little or no extra effort.\textsuperscript{6}

Consider the common situation where a bank provides a working capital line of credit to your buyer and obtains its own collateral by perfecting a lien on all of the assets now owned by the buyer as well as those acquired later. You then sell equipment to the buyer. In the absence of the special status given to “purchase money” financing, even if you had the buyer sign a security agreement and you filed a financing statement, the bank’s financing statement would have been recorded first and its lien would have priority. If the buyer went into bankruptcy, the bank would get the equipment.

An important additional requirement for obtaining purchase money priority must be satisfied if you are selling to a buyer who plans to resell or lease your equipment to others; \textit{i.e.}, a dealer, distributor or leasing company. In the hands of this kind of buyer, the equipment you are selling will be “inventory.”\textsuperscript{7} In addition to the normal steps to create and perfect your lien, you must also notify the other parties having a lien on your buyer’s inventory that you are going to provide purchase money financing. This important procedure will be discussed below.

Procedures

The following steps are an executive summary. You should confer with an attorney familiar with Article 9 who will help you with documentation and procedures customized for your business.

1. Obtain Accurate Information

To be able to take the necessary steps to protect your rights in the collateral, it is essential that you learn the actual, legal name of your borrower, not its trade name, and identify the state in which that borrower is incorporated or organized. You can usually verify the information your buyer gives provides by obtaining a good standing certificate from the applicable state government.

If your buyer has been located or conducted business in any state or states other than the one in which it is incorporated or organized since before July 1, 2001, you will also need a list of those states.

2. Prepare the Necessary Documentation

Next, have your buyer sign a security agreement, which creates the lien, and file a UCC financing statement with the Office of the Secretary of State where the buyer is incorporated or organized to perfect the lien.

---

\textsuperscript{6} UCC §9-324
\textsuperscript{7} UCC §9-102(48)
3. **Run UCC Searches**

Obtaining a search of filed financing statements is how you insure your financing statement is properly recorded, and determine if there are any other secured creditors who filed financing statements before you did that cover the equipment you are selling. If your buyer is going to use the equipment you are selling rather than reselling it or leasing it to others (i.e., it is not going to be inventory in your buyer’s hands), the searches are not critical, because if you utilize an appropriate security agreement and file your UCC Financing Statement, your lien on the equipment as well as its proceeds will be perfected because of your status as a purchase money lender. However, in the common circumstance where you are selling to a dealer or leasing company, the information obtained from the searches is vital.

You will always search where you are filing your financing statement (i.e., where your debtor is incorporated or organized). Until July 1, 2006, additional searching is needed outside of your dealer’s state of incorporation/organization, if your dealer was located or conducted business outside of that state at any time in the last five years.

Frequently, searching will reveal a buyer’s lender has a lien on all the buyer’s assets, including inventory and receivables. If there are other secured parties who have liens on your buyer’s inventory, and you are selling equipment that will be inventory in your buyer’s hands, you will need to take the next step.

4. **Notify the Buyer’s Other Secured Creditors**

Notifying the secured creditors who filed their financing statements before you did is necessary when your equipment is inventory in the hands of your buyer. The notification is a simple letter that must be sent prior the time your buyer receives the equipment. The notice states that you have or expect to have a purchase money security interest and describes the items you are selling.8

**“Proceeds”**

Even if you take care to monitor regularly the condition and location of your collateral, there is always a chance the equipment you sell to your customer will be resold, leased to a third party, damaged in a fire or flood, or otherwise disposed of by the time you attempt to recover it. “Proceeds” are what your customer receives in exchange for the equipment; e.g., cash, a promise to pay from its customer (a receivable), an insurance payment, or trade-in. Article 9 provides that “a security interest in proceeds is a perfected security interest if the security interest in the original collateral was perfected,”9 and that a perfected security interest in identifiable proceeds also has priority unless the original collateral is inventory.10

In limited circumstances, these provisions may be sufficient to protect your interests. However, problems can arise when there are other perfected secured creditors having a higher priority in the proceeds, where the collateral has been turned into cash that has been commingled

---

8 UCC §9-324(b)
9 UCC §9-315(c)
10 UCC§9-328(a)
with the debtor’s other cash, or where the cash has been deposited in your buyer’s bank and that bank is also owed money. Aside from these practical problems, a larger issue looms when your buyer is in the business of reselling or leasing the equipment (i.e., it is “inventory” in your buyer’s hands), because in most cases Article 9 simply does not give sellers purchase money priority in receivables generated by the sale of inventory. Your distributor’s accounts receivable, even if generated by the sales of your equipment, can be lost to your distributor’s lender unless extra steps are taken.

Options Regarding the Proceeds of Inventory

If your distributor has a sales financing program in place, you may be able to make a contractual arrangement under which the company financing the sale for the ultimate user pays off your debt directly upon the sale of the equipment. The direct payment may mitigate the risk of the distributor selling your collateral without giving you the proceeds of the sale, what is commonly referred to as “selling out of trust.”

If your search reveals the distributor’s lender has a lien on receivables, you may be able to enter into an “intercreditor” or “subordination” agreement under which the lender agrees that your lien on the accounts receivable generated by the distributor’s sales of your equipment will have priority over its lien, even though the lender filed its financing statement first.

Another possibility, albeit one that will generate more paperwork, is to establish a system where your distributor’s customers sign a note and security agreement in favor of your distributor (sometimes called “chattel paper”) and that chattel paper is then assigned to you.

The business decision that needs to be made is whether the extra steps necessary to establish your rights to the proceeds of your distributor’s inventory are justified by the amount of money at issue.

Remedies

Before exercising your rights as a secured party, it is advisable to contact your attorney for guidance. Article 9 does provide remedies to the debtor where the secured party fails to exercise its rights properly.

Article 9 provides that after default, a secured party may take possession of its collateral either with the involvement of the courts or without, if repossession can be accomplished without a breach of the peace. Once you have retrieved the collateral as a secured party, you may sell, lease, license or otherwise dispose of it and apply the receipts to your buyer’s obligation, as long as you comply with certain requirements. If the equipment has been sold and your buyer’s customer still owes the money, you can notify the customer to make the payment directly to you, if you are entitled to the proceeds.

---

11 UCC §9-324(b)
12 UCC §9-625
13 UCC §9-609
14 UCC §9-607
Conclusion

Your customers’ unsecured obligations to pay for equipment are a risk that is easily addressed. Article 9 of the UCC provides you with the tools to obtain a lien on the equipment you are selling to your buyers. An experienced attorney can show you how to obtain accurate facts, utilize appropriate documentation, file financing statements, run lien searches, notify other secured creditors, and make agreements with other creditors when necessary to give you some measure of protection from the risks of defaulting equipment buyers.