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The Arrow

PITFALLS IN FINANCING INVENTORY

Sometimes an actual example from our case files best illustrates and makes more understandable complicated legal issues. We thus now turn to an actual "war story" from our files to explore the pitfalls which inventory financiers may encounter. We have changed all names of the parties to protect the innocent and the guilty alike.

Let us consider the case of John Doe, d/b/a Doe Hardware, a small businessman in a small town in eastern Kentucky.

The day came when John, knowing that his business was losing money and that he needed very badly to stop the bleeding, decided to close his doors and file a Chapter 7 bankruptcy petition. First, however, he looked around his store and decided to contact three different suppliers who had placed different lines of lawn and garden equipment on his floor on credit. Since John had not paid for any of this inventory, he considered it only decent to call up these suppliers and tell them to reclaim their goods from his store.

The first Supplier, Acme Lawn Tractors, had placed three small tractors on consignment with Doe Hardware and was very happy to pick up its tractors the week prior to the petition. The second supplier, Binford Supply, was equally happy to pick up the various disc and other tractor attachments which it had placed in Doe Hardware's inventory. Binford's credit manager was sophisticated enough to have obtained a security agreement from John Doe and to have filed a financing statement ("U.C.C. - 1") on the product which it had provided to Doe Hardware.

Finally, Cojack Mowers also sent out a truck to relieve John Doe of the ten (10) lawn mowers which it had placed on his floor for sale. Cojack had not only obtained a security agreement and filed a financing statement on the mowers which it financed, but had also taken another step which proved to be crucial once John's bankruptcy petition was filed.

The following week John Doe filed bankruptcy and the only creditor to appear at his first meeting of creditors was Friendly Bank, by and through its counsel, who wanted to know what had happened to various inventory such as lawn tractors, lawn mowers, and tractor attachments which the bank believed to have been among the inventory of Doe Hardware shortly prior to its closing. John was happy to testify about how he had helped his suppliers retrieve their product because he believed it to be the correct thing to do. After all, as John testified, he did not want his various suppliers to have to go into the bankruptcy court to recover their tractors, mowers and attachments.

As soon as the first meeting was over, Friendly Bank's counsel immediately checked the local chattel lien (U.C.C.) records at the county courthouse and determined that of the three creditors to whom John Doe returned equipment, only two had filed financing statements of record – Binford and Cojack. Of course, there was also a financing statement on all inventory and proceeds filed by Friendly Bank, which filing was prior to all others in time. Friendly Bank's counsel passed this information along to the bank, and the bank then reviewed its file on Doe Hardware.

The bank found that it had received a written notice from Cojack Mowers to the effect that it was claiming a security interest in the Cojack mowers which it was supplying to Doe Hardware. Cojack's credit manager

had mailed this notice within ten (10) days of the filing of its financing statement and , upon further investigation by the bank's counsel, this date also proved to be ten (10) days after Doe received the mowers into its inventory from Cojack. Friendly Bank had no such notice in its file from either Acme or Binford, and upon request, neither Acme nor Binford could produce one.

Now, gentle readers, before you read further, can you make a determination as to which suppliers Friendly Bank's attorney will advise the bank to pursue of these three repossessing creditors: Acme, the consignment creditor; Binford, which took a security agreement and filed a financing statement of record in the proper place upon the inventory which it financed; and Cojack, which not only took a security agreement and filed a financing statement of record, but also simultaneously with the delivery of its collateral, put the prior inventory lienholder, Friendly Bank, upon notice of its intent.

First of all, let us consider Acme. Since Acme merely placed the goods on Doe's floor on consignment, doesn't it retain title to the goods, and isn't it properly protected? The answer, quite simply, is no. Consignment creditors like Acme need to file a financing statement and give notice to other inventory financiers in Kentucky or their rights are subordinate to the prior lienholders on the same inventory. With certain exceptions spelled out in KRS 355.2-326, a consignment agreement is generally no different from an Article 9 secured transaction. See KRS 355.9-114. Thus, Friendly Bank can sue Acme and recover back the inventory which Acme removed from the debtor's store (or its value).

But what about Binford and its more sophisticated credit manager? After all, Binford took a security agreement and filed a financing statement, and it financed Doe's acquisition of only specific Binford product. Shouldn't its specific security interest prevail over the prior filed blanket lien of Friendly Bank on all Doe's inventory?

The answer, quite simply again, is no. Although Binford could have leapfrogged over Friendly Bank's prior filed financing statement under U.C.C. Section 9-312, it failed to do so because it did not comply with the requirements – those same requirements with which Cojack complied when it not only took a purchase money security interest and filed a financing statement, but also sent notice to the prior lienholder on inventory, Friendly Bank, of what it was doing. As to the contest between Friendly Bank and Binford, the general rule of first in time, first in right, prevails – even though Binford's lien is purchase money.

The notice requirement of 9-312 makes perfect sense. Ordinarily, inventory lienholders do not check subsequent filings on their debtors' inventory, nor are they required to do so. Any representative from Friendly Bank visiting Doe Hardware prior to the petition would have been on notice that the Cojack lawn mowers were not collateral for Doe's obligation to the bank, but the bank representative would not have been on notice that the inventory furnished by Acme and Binford did not stand good for Doe's debt to the bank.

John Doe's attempt to help out his suppliers is understandable, but the law is definitely on Friendly Bank's side as to Acme and Binford. Only the credit manager of Cojack was able to retain the equipment which he had placed in Doe's inventory.