Principles of Business Credit

Eighth Edition

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PART II

THE LEGAL ASPECT

5 The Legal Forms of Business

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The importance of the customer's legal form of organization in credit decisions.
- The major features of proprietorships.
- The different types of partnerships.
- The major features of corporate organizations.
- The major features of S corporations.
- The major features of limited companies, estates, common law trusts, joint ventures, cooperative societies and non-profits.
- Other features of organizations that are relevant to credit professionals.

CHAPTER OUTLINE

Questions for Discussion

THINK ABOUT THIS

Q. Why should a seller understand a customer's legal standing? Does the buyer's form of business affect creditors' rights? Why or why not?

Q. What are the benefits of certain legal forms of business over others?

The Creditor's Interest in Legal Composition

- Importance of Legal Form
- Principal Forms
  - Proprietorship
  - Partnership
  - Corporation
  - Limited Liability Company

Proprietorships

A business owned and operated by one person

- Management
- Continuity
- Capital
- Liability

Comprehension Check

Why does a credit professional need to be concerned with what form of business a debtor is?

Partnerships

General Considerations

An association of two or more persons to carry on as co-owners of a business in order to share the profits and losses.

Typical points covered if a partnership contract is created:

- Type of business to be conducted.
- Amount of money or other valuable consideration to be invested by each partner.
- Division of profit and losses.
- Sharing of expenses.
- Powers and duties of each partner.
- Compensation to be paid to each in the form of salaries or draws.
- Duration of the partnership and how it is to be dissolved.
- Division of assets in case of dissolution.
- Provisions for withdrawal or admission of partners.
- How differences of opinion are to be settled.
- Provision for continuation in the event of one partner's death or incompetence.

Comprehension Check

What factors does a credit professional need to consider when dealing with a **proprietorship?**

General Partnership and Limited Partnership

General Partnership

"all partners are entitled to take an active part in the affairs of management, unless this is amended by the partnership agreement."

Limited Partnership

"is composed of one or more general partners and one or more limited partners."

- Continuity
- Capital
- Liability

Comprehension Check

Define the term **partnership.**

Limited Liability Partnerships (LLPs)

Designed for professionals who do business as partners in a partnership.

- General considerations
- Liability
- Dissolution

Comprehension Check

Describe the differences between a **general partnership** and **limited partnership.**

Corporations

"A voluntary association of persons, natural or legal, recognized as being a person, fictitious in character, and being entirely separate and distinct from the people who own it; having continuous life; and set up for a specified purpose."

- **Domestic Corporation**
- **Foreign Corporation**
- Certificate of Incorporation
- Continuity
- Capital
  - Capital Stock
  - Common Stock
  - Preferred Stock
- Liability

Comprehension Check

Describe some basic characteristics of a **LLP.**

S Corporations

"A corporation in all respects, except that the stockholders rather than the corporation pay the federal income taxes."

- Continuity
  - Be a domestic corporation.
  - Must have no more than 100 shareholders.
  - Have only one class of stock.
  - Have allowable shareholders (*may be* individuals, certain trusts and estates and *may not be* partnerships, corporations or non-resident alien shareholders). However, certain tax-exempt corporations, notably 501(c)(3) corporations, are permitted to be shareholders.
- Capital
- Liability

Comprehension Check
Define the word **corporation.**

Comprehension Check
What is **common stock** and what is **preferred stock?**

Limited Liability Companies (LLCs)

"The basic concept of the LLC is that an unincorporated business association, which desires to do business under the corporate structure, may do so by combining the benefits of a traditional C corporation and a partnership."

LLCs are different from S Corporations in several ways:

- LLCs are not limited to a specific number of shareholders.
- They are not restrictive in the type of individuals who can hold an interest in the association or the amount of interest the association can hold in another corporation

Comprehension Check

List the requirements of an **S Corporation.**

How an LLC is Formed

Pure Corporations

1. Associates.
2. An objective to carry on business and to divide the gains from there.
3. Continuity of life “of the entity.”
4. Centralized management
5. Limited liability.
6. Free transferability of assets.

- To be considered a partnership for federal taxation purposes, the Internal Revenue Service requires a business association, like an LLC, to possess more non-corporate than corporate characteristics.

Comprehension Check

To what extent do stockholders have liability for the debts of a corporation?

Retention of Partnership Status

There are three specific ways one can avoid possessing the three characteristics that can tip the balance toward being more of a corporation and less of a partnership:

- **Continuity of Life**
- **Centralized Management**
- **Free Transferability of Assets**

A properly structured LLC will avoid at least two of the three characteristics.

Comprehension Check

List the six characteristics of a **"pure corporation."**

Consideration for Creditors

There are, however, some considerations that should be reviewed when dealing with an LLC:

- Usually, LLCs are startup operations and are not part of an established group of entities.
- While there are tax advantages for both profits and losses, the pass-through of losses to the members is a very distinct advantage.
- Many times, when it is assumed that the entity will be losing money in its early stages, the LLC structure (or an S Corporation) is chosen to maximize the tax benefits of the losses for those involved on an individual basis.

Comprehension Check

How does an **LLC** differ from an **S Corporation?**

Estates

- Proprietorships - Continuity
- Capital
- Liability

Common Law Trusts

"Formed by agreement between owners of property (or a business) and a trustee or group of trustees."

- General considerations
- Continuity
- Capital
- Liability

Joint Ventures

"A combination of two or more persons or corporations formed to undertake a specific, usually large, contract or project."

- For credit analysis purposes, it is similar to a partnership. It is defined in case law as *an association of two or more persons (corporations) to carry out a single business enterprise for profit, for which purpose they combine their property, money, effects, skill and knowledge.*

- Continuity
- Capital
- Liability

Other Forms of Organizations

- Cooperative Societies
- Not-For-Profit or Nonprofit Organizations

Comprehension Check

Define the term **joint venture.**

Other Features of Organizations

Some of the more frequent situations are:

- Principals of one business are also principals of another, and there may be many transactions between them.
- Changes being made in legal composition, as when a proprietorship becomes a corporation.
- One company having its operations split into one or more divisions using separate names.
- Two or more businesses merging or consolidating, or one corporation acquiring another. In each instance, these actions could affect the customer's creditworthiness.

- Affiliated Interests
- Changes in Legal Composition
- Parent-Subsidiary Relationships
- Operating Divisions
- Mergers and Consolidations
- Purchase of Assets

Comprehension Check

Briefly discuss the relationship between a **parent corporation** and its **subsidiary.**

Summary

- The legal composition of a business may have a direct impact on a creditor's ability to get paid in the event of a business failure, change in legal composition or death. Depending on the legal status, a person's assets may or may not be available to pay back debts.
- A **proprietorship** is a business owned by an individual who assumes unlimited liability for the debts of the business. The proprietorship ceases when the owner dies or withdraws. In some cases it may be continued by the family or estate.
- There are three types of **partnerships:**
    - **General**
    - **Limited**
    - **Silent**
- In general, partnerships have command of more investment capital. General partners assume unlimited liability, while limited partners only assume the liability of the amount they invested. An attractive feature of partnerships is that it does not pay federal income taxes; rather, its partners pay taxes individually.
- In an **LLP,** the partners continue to have the benefit of a pass-through tax entity like in a general partnership. However, in an LLP, the partners are not held jointly accountable for other partner's actions. Parameters surrounding liability change by state, so it is important that credit managers consult their state laws in order to make an appropriate judgment of a debtor's accountability.

Comprehension Check

What is an **operating division?**

Summary Continued...

- The two types of stock issued by a corporation include: **common stock** and **preferred stock.** Although there are several differences, preferred stock normally has a higher priority to a company's claim than do those that hold common stock. However, common stock comes with other benefits such as voting rights within a corporation.
- **S Corporations** are a modified form of a corporation that allows the individual who owns or controls the corporation to only be taxed as an individual. This comes with certain restrictions that include:
  - Being a domestic corporation
  - No more than 100 stock holders
  - Only one class of stock offerings
  - Have allowable shareholders
  - It must earn 75% or more of its gross income from normal business function
- S corporations have the same immunity from business debts as any other shareholder.
- An **LLC** is a company that is created to model the traditional corporate structure while gaining the benefits of a partnership. LLCs are different from an S Corporation as follows:
  - LLCs are not limited to a specific number of shareholders
  - They are not restricted as to who can invest

Summary Continued…

- Apart from the six characteristics found in "**pure corporations**," an LLC must be more non-corporate than corporate and normally do this by not possessing two of the following characteristics: continuity of life, centralized management or free transferability of assets.
- When dealing with **estates,** creditors can become a representative of the estate, and if there is a considerable amount of debt owed, they should ensure that the assets have been properly classified. Death does not shorten the statute of limitations on unsecured claims, but the time of enforcement may be lengthened.
- As a creditor, it is important when working with **joint ventures** to ask the joint venture to state in writing who is liable and for what part of the debt. It is also important to assess the individual financial strengths of each party.
- **Cooperative societies** should be given credit based on their balance sheet numbers and member support as indicated by the profits earned.
- **Non-profits** operate almost identically to for-profit businesses; therefore, their creditworthiness should be assessed based on their financial statements.
- Other features of organizations that may have a dramatic effect on the creditworthiness of a business are: when a person has affiliate interests, when there is a change in the legal composition of a company, when there is a parent-subsidiary relationship, or when mergers and consolidations occur.
- As a general rule, when extending credit to a division of a company, the analysis should not be done as if the division is a separate entity.

6 The Legal Environment of Credit

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The four cornerstone federal antitrust acts and why they were written into law.
- The Fair Credit Reporting Act and its applications in consumer and commercial credit.
- The applicable practices a creditor must follow under the ECOA and Regulation B.
- The purpose of the Consumer Financial Protection Bureau.
- The rules that a creditor must follow under the Fair Debt Collection Practices Act when collecting from a debtor.
- What information a creditor must disclose to a consumer applying for credit under the Truth in Lending Act and Regulation Z.
- What constitutes an e-signature and its relevant provisions.
- The procedures and requirements a holder of unclaimed property must follow.
- Why SOX was enacted and its requirements for corporate responsibility and accountability.
- The Red Flags Rules.

CHAPTER OUTLINE

Questions for Discussion

THINK ABOUT THIS

Q. How has human behavior influenced the evolution of laws in the business environment?

Q. How has technology influenced the business and legal environment?

Antitrust Regulation

"Antitrust laws were initially enacted around the turn of the 20th century in response to the damaging effects that powerful monopolies, formed by corporate giants and others in the mid- to late-19th century, were having on small businesses."

The purpose of U.S. antitrust law is to encourage and protect competition.

The four main antitrust regulations include:

1. The Sherman Act
2. The Clayton Act
3. The Robinson-Patman Act
4. Federal Trade Commission Act

The Sherman Act of 1890

Prohibits contracts, combinations and conspiracies in restraint of trade in interstate commerce.

Every person who shall monopolize or conspire with another person to monopolize any part of the trade or commerce shall be deemed guilty of a felony, punishable by fine not exceeding $100,000,000 if a corporation, or, if any other person, $1,000,000, or by imprisonment not exceeding 10 years, or both.

In determining if an action constitutes a conspiracy to commit an action that results in a restraint of trade, four elements must exist:

1. There must be knowledge of all the parities;
2. A common purpose;
3. An actual restraint of trade; and
4. Intent to restrain trade.

Comprehension Check

What is the purpose of **U.S. antitrust law?**

The Clayton Act of 1914

The Clayton Act was created to correct defects in the Sherman Act.

Makes it unlawful to enter into:

1. Leases or sales on condition that lessee or purchaser shall not use or deal in the commodities of a competitor
2. Exclusive dealing arrangements
3. Tying arrangements

Comprehension Check

What is the **Sherman Act** designed to prevent?

Federal Trade Commission Act

- Broadest of antitrust acts
- Prohibits false advertising of foods, drugs, devices and cosmetics
- Administers Telemarketing Sales Rule, Pay Per Call Rule and Equal Credit Opportunity Act

The Robinson-Patman Act of 1936

Forbids price discrimination where the effect is to substantially reduce competition or to create a monopoly.

The Robinson-Patman Act is of particular importance to credit professionals.

Price discrimination includes:

- **Different prices charged to different purchasers**
- **Differences in terms and conditions of sale**
- **Preferential credit terms**
- **Credit terms are an inseparable part of price according to a 1980 Supreme Court decision**

Antitrust Regulations and Credit

- Price-fixing
- Price Discrimination
  - Different price charged to different purchasers
  - Differences in terms and conditions of sale
  - Preferential credit terms

Permission Granting of Preferential Credit Terms

- **Good Faith**
- **Verifying Competitive Offers**
- **Legitimate Business Reason**
  - Differences in cost of manufacturing, sale or delivery
  - Differences in market conditions
  - Differences in company’s credit risk

Comprehension Check

What does the **Robinson-Patman Act** specifically forbid?

Other Important Antitrust Legislation

- The Antitrust Procedures and Penalties Act
- The 1976 Antitrust Act

Comprehension Check

What types of business practices does the term **price discrimination** include?

The Fair Credit Reporting Act

- Guarantees a consumer's right to know credit information maintained by credit bureaus and be given a specific reason if credit is denied
- Defines personal or consumer credit as for "personal, family or household purposes."
- Specifies rules for consumer reports
  - Under Section 604(3)(F) of the Fair Credit Reporting Act, the requesting creditor may only request a consumer report if there is a legitimate business need for the information, meaning that the need is:
    1. In connection with a business transaction that is initiated by the consumer; or
    2. To review an account to determine whether the consumer continues to meet the terms of the account.

The Equal Credit Opportunity Act and Regulation B

- Promotes the availability of credit without regard to race, color, religion, national origin, sex, marital status or age
- Applies to all credit, commercial and personal
- Spouses and Personal Guarantees
- Noticing requirements
- Keeping Records and Penalties
- Discrimination Measured by Effects Test
- Electronic Communication
- Compliance

Comprehension Check

What is the purpose of the **Fair Credit Reporting Act?**

Adverse Action

1. **Refusal to grant credit**
2. **Refusal to increase credit**
3. **Reduction of credit**
4. **Termination of credit**

The following are **not** considered adverse actions:

1. A change in the terms of an account expressly agreed to by an applicant.
2. Any action or forbearance relating to an account taken in connection with inactivity, default, or delinquency as to that account.
3. A refusal or failure to authorize an account transaction at point of sale or loan except when the refusal is a termination or an unfavorable change in the terms of an account that does not affect all or substantially all of a class of the creditor's accounts or when the refusal is a denial of an application for an increase in the amount of credit available under the account.
4. A refusal to extend credit because applicable law prohibits the creditor from extending the credit requested.
5. A refusal to extend credit because the creditor does not offer the type of credit or credit plan requested.

Comprehension Check

What is the purpose of the Equal Credit Opportunity Act?

Dodd-Frank Wall Street Reform and Consumer Protection Act

- Established the Consumer Financial Protection Bureau (CFPB). Applies only when using a consumer credit report.
- ECOA notifications and disclosures to a credit applicant are only applicable when the trade credit grantor makes an adverse credit decision.

Comprehension Check

The **ECOA** defines the term adverse action. List the four types of action that qualify as adverse under the ECOA.

The Fair Debt Collection Practices Act

- Created to make fair laws for the benefit of debtors when a creditor attempts to recover debts.
- Creditors are exempt from the FDCPA if collecting their own debts in their own name.

The following is a partial list of the practices prohibited by the FDCPA:

- Misrepresenting the character or amount of a debt.
- Threatening to take action prohibited by law.
- Threatening to take action that is not intended to be taken.
- Using profane, obscene or abusive language.
- Making repeated calls for the purpose of harassment.
- Reporting a disputed debt to a credit bureau without disclosing that it is disputed.
- Reporting a "stale" debt to a credit bureau.

Comprehension Check

What is the purpose of the **Dodd-Frank Wall Street Reform Act?**

The Truth in Lending Act and Regulation Z

- Protects and educates consumers about purchasing credit
- Sellers of credit must disclose interest rates, finance charges and fees
- Fair Credit Billing Act - *Creditors are required to correct errors promptly while at the same time preventing the errors from showing up on consumer credit reports*
- TILA and Regulation Z exempt credit transactions involving extensions of credit primarily for: business; commercial or agricultural purposes; or to government or governmental agencies or instrumentalities; or to organizations.

It also exempts:

  - Transactions in securities or commodities accounts by broker-dealers registered with the Securities and Exchange Commission;
  - Credit transactions, other than those in which a security interest is or will be acquired in real property or in personal property used or expected to be used as the principal dwelling of the consumer, in which the total amount financed exceeds $25,000; and
  - Transactions under public utility tariffs, if the Board of Governors determines that a state regulatory body regulates the charges for the public utility services involved, the charges for delayed payment and any discount allowed for early payment.

Comprehension Check

How does the **Fair Debt Collection Practices Act** affect the collection of a debt by a debt collector?

E-Sign Act

The E-Sign Act set the enforcement of electronic communications in motion and provided a template for laws governing electronic signatures and communications subsequently put in place throughout the country.

In Section 7001(a), the E-Sign Act provides:

1. A signature, contract, or other record relating to such transaction may not be denied legal effect, validity, or enforceability solely because it is in electronic form; and
2. A contract relating to such transaction may not be denied legal effect, validity, or enforceability solely because an electronic signature or electronic record was used in its formation.

E-Sign Act defines electronic signature *as an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record.*

Comprehension Check

What is the purpose of the **Truth in Lending Act?**

Electronic Signatures and Credit

For the credit professional, an e-signature may eliminate a customer's need to download an application and mail the completed application with a handwritten signature. Some of the relevant provisions of the E-Sign Act are:

- Parties to the contract decide on the form of digital signature technology to validate the contract.
- Businesses may use e-signatures on checks.
- Businesses must require parties to the contract to make at least two clicks of a computer to complete a deal.
- The consumer decides whether to use an e-signature or handwritten signature.
- Cancellation and foreclosure notices must be sent on paper.
- E-signatures on adoptions, wills, and product safety recalls are not allowed.
- Records of e-contracts may be stored electronically.

Comprehension Check

List two provisions of the **E-Sign Act.**

Unclaimed Property Law (Escheatment)

Tangible or intangible property owed to a person or entity (the owner), yet held by another (the holder).

- An account's credit balance may qualify
- State becomes legal owner
- States consider it a source of revenue

- All States, the District of Columbia, U. S. Virgin Islands, Puerto Rico, and Guam have enacted unclaimed property laws
- Interest on the property, state fine, penalties and damages may be applicable if property is not escheated properly.
- Business-to-Business Exemption
- Risk of Not Escheating
- Escheatment Audit
- Turning Over the Property

Comprehension Check
What are some advantages of **e-signatures?**

Steps to Protect Against Escheatment Claims

1. Determine the situation
2. Determine eligible property
3. Perform the due diligence
4. Prepare reports and remittances
5. File reports and remittances
6. Follow up and reconcile

Comprehension Check

Define **unclaimed property.**

Sarbanes-Oxley Act of 2002

Protects investors by improving the accuracy and reliability of corporate disclosures

- Eleven Titles
- Retain documents for seven years

The principal objectives addressed in the Act can be grouped into the following themes:

- To strengthen and restore confidence in the accounting profession;
- To strengthen enforcement of the federal securities laws;
- To improve the "tone at the top" and executive responsibility;
- To improve disclosure and financial reporting; and
- To improve the performance of "gatekeepers."

Comprehension Check
If a holder determines it has unclaimed property, what due diligence is required?

Comprehension Check
Why is it important to properly report and remit unclaimed property?

Section 404

- Section 404 mandates that companies evaluate the effectiveness of their internal controls by having their certifying officers consider two basic questions:
  1. Do the employees of the company understand what they need to do to properly prepare external financial reports?
  2. What information do the company officers need to make sure their employees have complied?
- Three steps can help address these two questions:
  - Identify financial reporting risks and the controls that address them.
  - Ensure that the controls work in practice.
  - Report the conclusions on overall effectiveness and deficiencies.

Comprehension Check

Why did Congress enact the **Sarbanes-Oxley Act of 2002?**

Credit managers may be asked to sign off on documentation about accounts receivable and credit risk.

Red Flags

Red Flags *are any pattern, practice or specific activity that indicates the possible risk of identity theft; companies need to identify the Red Flags specific to it by identifying the types of accounts offered or maintained.*

Limits the applicability to a creditor that regularly and in the ordinary course of business:

- Uses consumer reports in connection with a credit transaction
- Furnishes information to consumer reporting agencies in connection with a credit transaction or
- Advances funds to or on behalf of a person based on their obligation to repay the funds
  - “Advances funds” refers to money, not goods or services

Summary

- Understanding the legal environment surrounding business on national and state levels is critical to a credit professional's role. Legislation protects the rights of creditors as well as poses limitations to business activity. Penalties and criminal action that may be filed against individual credit professionals and the business if conduct is found to be outside the boundaries of the law.
- Antitrust regulation was enacted at the turn of the 20th century to mitigate the effect of powerful monopolies on small businesses. The four major federal acts combating monopolies include:
  - **The Sherman Act**
  - **The Clayton Act**
  - **The Robinson-Patman Act**
  - **The Federal Trade Commission Act**
- The **Sherman Act** was designed to prevent monopolies and unfair restraints of trade. Although it does not prohibit all restraints of trade, it does outlaw contracts, combinations, or conspiracy to restrain trade, and monopolization that is deemed unreasonable.
- The **Clayton Act** was created to correct the shortcomings of the Sherman Act. It gives administrative agencies the power to stop violations of the law before they develop into actuality. The law makes it unlawful to create exclusive dealing arrangements, as well as any deal containing arrangements that involved restricting the sale to or from a competitor. It also restricted companies from obtaining stock of other companies that would considerably lessen the competition in the market place.
- The **Federal Trade Commission Act** is the broadest act and prohibits any act that attempts or is designed to deceive the public.
- The **Robinson-Patman Act** is designed to target direct or indirect price discrimination. This is particularly important to credit professionals, and involves:
  - A different price charged to different purchasers of the same type
  - Differences in terms and conditions of sale
  - Preferential credit terms
  - Credit terms which are an inseparable part of price

Comprehension Check

What is the **Red Rlags rule?**

Summary Continued…

- For a person to be found liable for price discrimination there is no need for an arrangement, combination, association or conspiracy. They only need to be engaged in at least two transactions crossing state lines, and for the consumption or resale within the United States.
- Meeting competition is the most common defense against claims of unlawful price discrimination.
- The **Fair Credit Reporting Act (FCRA)** requires consumer credit reporting agencies to adopt reasonable procedures to meet the needs of consumer credit, employment, insurance, and all other information that is fair and equitable to consumers. It concerns credit extended to consumers and not commercial credit transactions. The law states that a credit report may not be initiated or requested without the written consent of the individual and there is a permissible business use defined by statute.
- The **Equal Credit Opportunity Act and Regulation B (ECOA)** was created to promote the availability of credit regardless of one's race, color, religion, national origin, sex, marital status or age.
- With gross revenues of $1 million or less in the preceding fiscal year, the creditor must provide written or oral notice of **adverse action** within 30 days of receiving the application. Adverse actions are:
  - Refusal to grant credit
  - Refusal to increase credit on an existing account
  - Reduction of credit availability on an existing account
  - Termination of credit on an existing account
- A credit hold is not deemed adverse if the account has been slow to pay or is delinquent. If a creditor violates a provision of the **ECOA**, they are liable for actual damages sustained by the applicant. With all costs included, **ECOA** damages can be detrimental.
- Any disclosure can be provided electronically as long as it is clear and the creditor has obtained the applicant's affirmative consent to obtained electronic communication.

Summary Continued…

- The **Dodd-Frank Wall Street Reform and Consumer Protection Act** establishes a **Consumer Financial Protection Bureau (CFPB),** and has a primary mission to monitor consumer lending. It also requires the disclosure of the principal reasons for denying or taking adverse action against an application for an extension of credit.
- The **Fair Debt Collection Practices Act** was created to make fair laws for the benefit of debtors when creditors attempt to recover debts. The **FDCPA** focus is on the collection activities of third-party collectors. Prohibitions include, but are not limited to, the following:
  - Misrepresenting the character or the amount of a debt
  - Threatening to take action prohibited by law
  - Threatening to take action that is not intended to be taken
  - Making repeated calls for the purpose of harassment
- The **Truth in Lending Act (TILA)** was created with the intention of protecting and educating consumers in the field of purchasing credit. Sellers of credit are mandated by law to disclose certain information when offering credit. This includes information regarding the interest rates, finance charges and fees that will apply when accepting such credit terms.
- **E-Sign Act** was instituted to continue the facilitation of electronic commerce. It is vital to understand that e-signatures may not be denied legal effect, validity, or enforceability solely because they are in electronic form, and just because an electronic signature was used in the creation of a contract relating to a transaction. It is also important to understand that an email can constitute a valid and enforceable agreement.
- E-signatures make business on a domestic and international level faster and more efficient. They benefit both businesses and consumers from a legal standpoint, as well as reduce administrative work associated with printing, signing and rescanning a document in order to send it electronically.
- Due to the need for increased security after the events that took place on September 11th, states have looked for other sources of revenue, which has made escheatment an appealing source of revenue. **Escheatment** is the states right to unclaimed property. Laws differ by state, so it is important for credit professionals to know and understand the laws of escheatment in their particular state or fines, penalties and damages may be taken against a business.

Summary Continued…

- The **Sarbanes-Oxley Act (SOX)** was instituted to protect investors by improving the accuracy and reliability of corporate disclosures. The overarching goals of the act were to restore investor confidence and assure the integrity of business practices within the United States. The main objectives are to:
  - Strengthen and restore confidence in the accounting profession
  - Strengthen the enforcement of the federal securities law
  - Increase executive responsibility
  - Improve disclosure and financial reporting
- The main components of the act include, but are not limited to, the creation of a **Public Company Accounting Oversight Board PCAOB),** the use of independent auditors, the requirement of executives to be responsible for the accuracy of all public documents, the use of **generally accepted accounting principles (GAAP**), and the disclosure of any known conflict of interest.
- As of November 2007, the **Fair and Accurate Credit Transactions Act (FACTA)** requires financial institutions and credit managers to develop and implement identity theft programs. **Red Flags** are any potential risks that could arise in terms of identity theft.
- As a business, it is important to:
  - Do a risk assessment to identify relevant red flags
  - Detect red flags
  - Respond appropriately to red flags to mitigate risks of identity theft
- Update the written program periodically to reflect changes in risks to consumers or to business from identity theft
  - Have oversight dedicated to a company's Red Flags program

7 The Uniform Commercial Code

DISCIPLINARY CORE IDEAS

After reading this chapter, the reader should understand:

- The history of the UCC.
- Article 2: Sales.
- Article 2A: Leases.
- Article 6: Bulk Sales.
- Article 9: Secured Transactions.

CHAPTER OUTLINE

Questions for Discussion

THINK ABOUT THIS

Q. Is the Uniform Commercial Code uniform? Why or why not?

Q. How would buyers and sellers conduct business without uniform laws across the 50 states?

Q. What are some expectations a buyer may have upon receiving a product or service?

Q. Under what conditions would a company want a tangible asset to secure an extension of credit?

A Brief Guide to the UCC

- Designed in 1942
- **Not** federal law; each state adopts the Code and may make variations. Louisiana is the only state that hasn't adopted the Code in its entirety.
- The UCC covers every phase of commercial transactions involving the sale and payment of goods.
- Divided into 9 Articles

Article 2: Sales (Effective 2002)

Applies to sale transactions in goods.

- Goods - are all things, other than money, stocks and bonds, that are movable. Includes unborn animals and growing crops.
- Merchant
- Location of title
- Obligation of good faith
- Tender delivery
- Title

Comprehension Check

Under Article 2, what rule applies to sales worth more than $500?

Comprehension Check

Why does Article 2 distinguish between a merchant and casual or inexperienced sellers?

Risk of Loss

Shipping terms that create shipment contracts:

- FOB (Free on Board)
- FAS (Free Alongside)
- CIF (Cost, Insurance & Freight)
- CFR (Cost and Freight)

Shipping terms that create destination contracts:

- FOB Destination
- Ex-Ship
- No Arrival, No Sale

Comprehension Check

Article 2 applies to which kind of transactions?

Article 2: Sales Continued…

- Reclamation and Stoppage of Delivery
- Warranties
  - **Express**
  - **Implied**
    - There are four basic types of implied warranties:
      1. An implied warranty of merchantability.
      2. An implied warranty of fitness for a particular purpose.
      3. An implied warranty that is derived from a course of dealing or usage of trade.
      4. An implied warranty of title (owner has title to the item)

Comprehension Check

Within UCC Article 2, every contract has an obligation of good faith or honesty in the transaction concerned. Why is this an important concept?

Merchantability *is the concept that goods are reasonably fit for the general purpose for which they are sold*.

Comprehension Check

What does **tender delivery** mean?

What options does a buyer have if goods delivered by the seller do not conform to the contract?

If a buyer refuses to accept goods that conform to the contract, how can the seller determine the damages for which the buyer is liable because of the breach of contract?

Real World Perspectives

RWP 7-1

RECLAMATION DEMAND CURES THE JOHN DOE BLUES

Many years ago, there was a regional retail chain customer in the Mid-Atlantic States, and for this story, let's call them, the John Doe Widget Company. They were always difficult to deal with: chronically late with payments, constantly needing several collection calls per invoice, and they always took deductions on anything and everything.

The company's name became a verb in our office lexicon, as in "We've been John Doe'd again!" This company set the standard now used by today's big-box stores that use accounts payable as a profit center with those same tactics. John Doe was the master of evasion and deductions!

Over several years, the John Doe Widget Company expanded by buying not one, but two, smaller chains that were in bankruptcy. With its expansion, they became even more difficult to deal with; payments got even slower, requests for deductions increased, constant calls were required for collections. More chasing. More frustration. Why were we surprised? We talked to supervisors, managers, the controller, the finance director, the chief financial officer—you name it, we talked to them to get paid.

After months of intense run-around, enough was enough. I was done playing their games and took a tough stance. The John Doe Widget Company account was flagged against any new business. That got their attention. Once the account was current, we shipped existing confirmed orders, but did not take any new ones. And the cycle would start again: slow payments, unreasonable requests for deductions, and again a flag was placed on their account. One day, they called, desperate to receive one of their confirmed orders. After getting a commitment from John Doe's finance director that they would overnight payment for their outstanding invoices in exchange for letting two more truckloads of products ship, I approved the new purchases.

As one can guess, the overnight did not arrive. One truck had already delivered; the other was in transit and I had no way to stop the delivery. No one was taking my calls—not even the finance director who made the promise the day before. "John Doe'd again!"

I was young, having just completed NACM's Credit Administration Program. With the information from the legal class fresh in my mind, I sent a reclamation letter overnight, demanding that my material be returned immediately. I immediately received a call from their legal counsel asking why I had sent the demand letter. In my youthful enthusiasm, I stated emphatically, "You're not meeting your debts as they come due, which is one definition of insolvency and apparently you don't have the money to pay me. If this is the case, then I would like to come and get my material." The attorney assured me that his client was indeed solvent and that this whole thing was unnecessary. I asked for immediate payment of everything, and he stated he would see what he could do.

After a few days and several unreturned calls to the attorney, I received a check for all open invoices with the attorney's letter restating that his client, the John Doe Widget Company, was indeed solvent. It was just a misunderstanding, he wrote, and enclosed were the appropriate payments.

Sixty days later, the John Doe Widget Company filed for bankruptcy, and 60 days after that came the notice from the bankruptcy trustee with a preferential payment demand for $40,000. I provided my reclamation documents and the attorney's letter assuring me of the debtor's solvency. Happily, I never heard from the trustee again. At least we got the last hurrah after years of being "John Doe'd."

Loretta April

Article 2A: Leases (Effective 2002)

Leases *are the transfer of the right to possession and use of goods for a term in return for consideration.*

- Consumers and businesses lease a variety of goods
- Help firms with limited capital budgets
- Enforcing lease contracts

- General Default

Comprehension Check

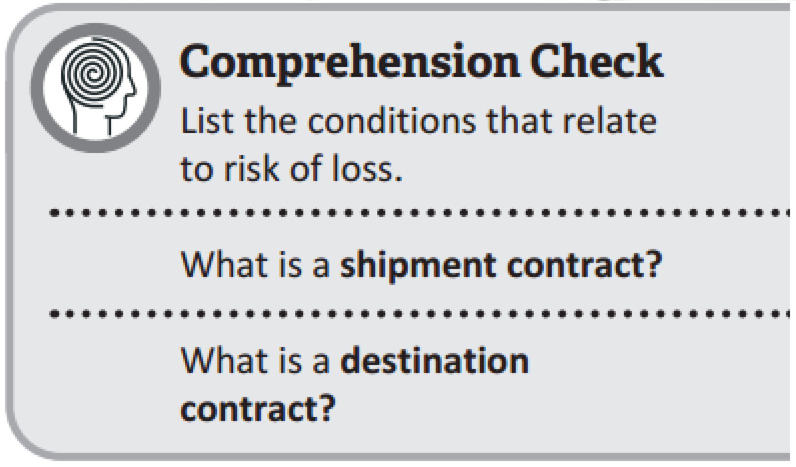
Define the term **warranty.**

What is an **express warranty?**

What is an **implied warranty?**

Article 6: Bulk Sales (Effective 1989)

- Protects creditors of a merchant by voiding bulk transfers not in the ordinary course of business without written notice.
- **Bulk transfer** *is any transfer of a major part of the materials, supplies, merchandise or other inventory of an enterprise that is not made in the ordinary course of business;* under revised Article 6, the transferor must be going out of business as well
- Designed to avoid two types of fraud.
- Requirements for bulk transfer
- Creditors' actions


Comprehension Check

List the conditions that relate to risk of loss.

What is a **shipment contract?**

What is a **destination contract?**

Article 9: Secured Transactions (Effective 2013)

- *Whenever the payment of a debt is guaranteed, or secured, by personal property owned by the debtor or in which the debtor has a legal interest, the transaction becomes known as a* **secured transaction.**
- Terminology of Secured Transactions
  - **Collateral**
  - **Debtor**
  - **Financing Statement**
  - **Secured Party**
  - **Security Agreement**
  - **Security Interest**

Comprehension Check
What does the general title section of the UCC state?

Comprehension Check
What does **reclamation** mean under Article 2?

Article 9: Excepted Transactions and Theory

- Excepted Transactions
  - **Mechanic’s LIens and other statutory liens**
  - **Aircraft, ships, and motor vehicles**
  - **Wages**
  - **Insurance contracts**
- Theory of UCC Sections on Creation of Security Interests in Personal Property

Comprehension Check

When is a lease contract enforceable?

Article 9: Classification

- Classification of Collateral
  - Accounts and general intangibles
  - Deposit accounts
  - Goods, such as inventory and equipment
  - Instruments
  - Investment property
  - Chattel paper (any writing evidencing a debt secured by personal property)

Comprehension Check

What is the general concept behind Article 6?

Under UCC Article 6, five requirements must be followed whenever a **bulk transfer** is made. What are they?

Article 9: Primary Use and Creation

- Determining Primary Use or Purpose
- Creation of Security Interest
  - Creditor provided value to debtor.
  - Debtor has rights in the collateral and the power to transfer such rights to the secured party.
  - Valid security agreement describes the collateral

Security Agreements Must Contain:

- **Identification of debtor and secured party**
- **Granting clause**
- **Collateral description**
- **Debtor's warranties, covenants and agreements**

Article 9: Perfection

The process of taking legal steps to ensure a secured party's interest in collateral will withstand attack by competing secured creditors, judgment lien creditors and a bankruptcy trustee.

Perfection by:

- Possession
- Control
- Filing a UCC financing statement

Comprehension Check

Under UCC Article 9, what is a **secured transaction?**

What is a **security interest?**

Figure 7-2 Perfection Methods by Type of Collateral

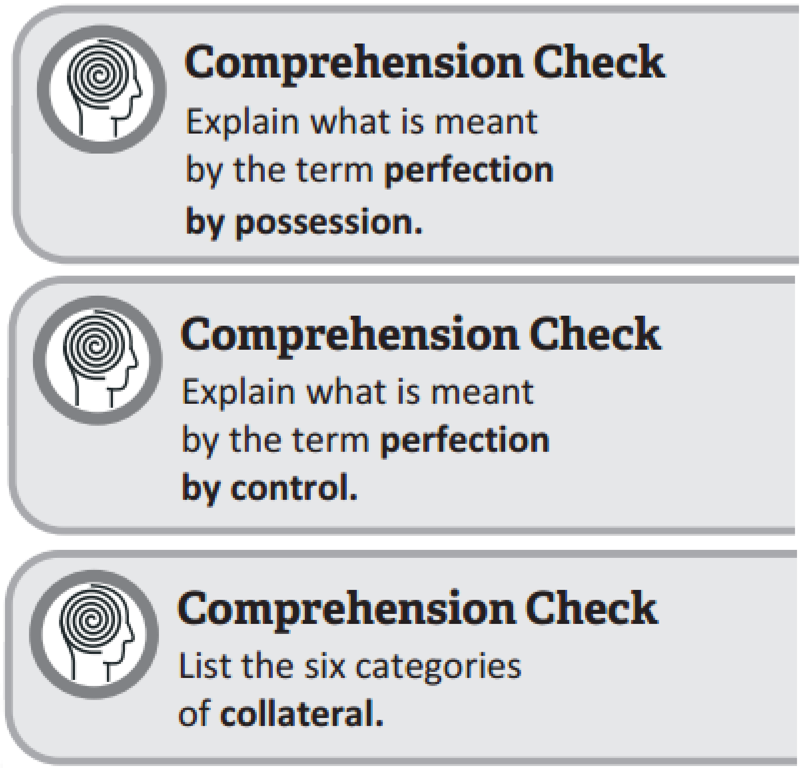
Type of Collateral	Method of Perfection Under Article 9
Accounts	Filing (9-310(a))
Agricultural Liens	Filing (9-310(a))
Certified Securities	Possession or Filing (9-313(a))
Commercial Tort Claims	Filing (9-310(a))
Deposit Accounts	Control (9-312(b)), (9-314(a))
Electronic Chattel Paper	Filing (9-312(a)) Control (9-314(a))
General Intangibles	Filing (9-310(a))
Goods	Filing (9-310(a), 9-312(c)) Possession (9-313(a) and (b))
Healthcare Insurance Receivables	Filing (9-310(a)) Attachment (9-309(5))
Instruments	Filing (9-312(a)) Possession (9-313(a))
Investment property (other than certified securities)	Filing (9-312(a)) Control (9-314(a))
Letter-of-Credit Rights	Control (9-312(b)(2), 9-314(a))
Money	Possession (9-312(b)(3), 9-313(a))
Negotiable Documents	Filing (9-310(a), 9-312(a)) Possession (9-313(a))
Oil, Gas or Other Minerals Before Extraction	Filing (9-310(a))
Tangible Chattel Paper	Filing (9-312(a)) Possession (9-313(a))

Comprehension Check

What transactions are excepted from Article 9?

UCC Financing Statement

- Where to file
- Must contain:
  - Name of debtor
  - Name of secured party
  - Description of collateral



Article 9

- Priority rules
- Purchase money security interest
- Consignments
- Merger/Successor debtor
- Perfection of security interests in specialized collateral
- Default and Enforcement
  - Definition
  - Collection Rights
  - Etc.

Comprehension Check

What is **perfection?**

Comprehension Check

Why is determining primary use or purpose critical?

Real World Perspectives

RWP 7-2

PMSI (PURCHASE MONEY SECURITY INTEREST) HELPS LEAD THE WAY TO SATISFACTION

The Credit Situation: Historically, Donlamor, Inc. had been a high-volume retail customer of Pennsylvania House furniture (subsidiary of La-Z-Boy). In better times, the retailer had a high credit of $450,000. However, during difficult economic times, the retailer's financial condition deteriorated, causing a reduction of the credit limit to $150,000.

At the beginning of the year, Donlamor owed Pennsylvania House approximately $130,000. Due to cash flow constraints, the retailer's ability to pay the existing balance was questionable. The retailer had a backlog of consumer orders totaling $630,000 at wholesale cost. Consumer deposits on these orders were around $300,000. If the orders could not be filled, we determined that it would create tremendous consumer dissatisfaction with our brand name, even though our company would not be directly responsible for the unfilled orders.

Pennsylvania House inventory security included a purchase money security interest (PMSI) in the retailer's inventory and personal guarantees from the principals. Since any inventory released would be shipped immediately to consumers, the new inventory would not be available as collateral. The financial statements of the guarantors would not justify a significant increase in the credit limit.

The Problem: Whether to take a loss of the existing balance of $130,000 or to risk increasing the credit to as much as $650,000 so that the backlog orders could be filled.

The owner of Donlamor proposed granting Pennsylvania House a second mortgage in a warehouse (net equity of $230,000) and first lien in other floor samples (estimated wholesale value of $200,000). We could justify loaning 80 to 90 percent of the equity in the warehouse and 50 to 70 percent of the inventory value. On paper, this would have justified a credit increase of about $280,000 to $350,000.

To prevent the retailer from immediately exhausting the additional credit extension (and leaving half of the backlog orders unfilled), we required that 70 percent of each order released be paid immediately once the merchandise was loaded onto a truck and ready for shipment. The retailer's normal practice had been to collect the remaining balance from the consumer, once the furniture was ready for shipment. Our thought was that the consumer collections would partially or fully fund the 70 percent cash-in-advance requirement. The remaining 30 percent of each invoice would be added to a revolving promissory note secured by the warehouse and the other inventory. Ten monthly payments of around $35,000 would pay the revolving note in full (with interest at prime plus 1 percent). The benefits: (a) the existing balance could be paid over 10 months, (b) about $650,000 in new sales would be recognized by Pennsylvania House, (c) consumer dissatisfaction of cancelled orders would be avoided and (d) about $12,500 interest would be earned on the revolving note.

The Outcome: Pennsylvania House was aware of another retailer who expressed a desire to expand its business. After extensive negotiations, the Pennsylvania House "gallery" portion of the Donlamor business was sold and the selling price of $240,000 was pledged to Pennsylvania House, which also reduced exposure.

The entire transaction represented approximately $800,000 invoiced, including prior exposure and completed consumer shipments. The promissory note was essentially pre-paid as the customer remitted $365,000 within five weeks, and we transferred $160,000 of inventory to the new retailer. We also reduced the receivable by $240,000 based on a six-month interest bearing (prime plus 1 percent) signed by the new buyer and payable to Pennsylvania House.

We not only were able to protect our accounts receivable assets, but we also satisfied numerous deposit consumers. We subsequently shipped $300,000 to the new buyer for floor samples and back-up stock. The entire transaction resulted in more than $1.1 million of added sales for Pennsylvania House.

$800,000	— A/R
($400,000)	— payments
($160,000)	— inventory transfer
($240,000)	— sale of Pennsylvania House gallery
$ 0.00	— net

Dave Carpenter

Real World Perspectives

RWP 7-3

CHAPTER 11 FILINGS CAUSE HAVOC FOR AN UNPERFECTED CONSIGNMENT CREDITOR

Sports Authority Holdings, Inc. and seven related corporations ("referred to herein as TSA") filed Chapter 11 proceedings on March 2, 2016. Approximately 170 consignment vendors sold inventory to TSA under various consignment or vendor agreements. Among the first-day motions filed by TSA was a motion to authorize TSA to continue to sell its consignment inventory in the ordinary course of business, provide replacement liens to consignment vendors in post-petition inventory and continue to pay consignment vendors in the ordinary course of business. TSA's motion stated how important consignment vendors are to its continued business operations because they allow TSA to "receive and resell a wide range of popular goods in [its] stores without having to commit working capital up front to cover the cost of selling such inventory." TSA stated further that it relies "on their ability to provide a wide selection of goods to meet customers' needs and drive customers' traffic."

Consignment vendors were excited to see this motion filed by TSA until the language within the motion was read carefully. Within that motion, TSA stated that it would only grant replacement liens to and/or pay the consignment vendors that have "[a] valid, enforceable, non-avoidable and perfected lien on consigned goods."

In one fell swoop, TSA promised protection to the consignment vendors and then took it away. As information has unfolded, it appears that about 90% of the TSA consignment vendors did not provide notification to prior secured creditors and did not file proper UCC Financing Statements.

TSA has now commenced a multitude of adversary proceedings (lawsuits) against consignment vendors seeking to have the Bankruptcy Court declare these consignment vendors to have unperfected security interests, permitting TSA to sell all inventory unfettered by these consignments and deem these consignment vendors to be nothing other than general unsecured creditors.

Clearly, that is a far cry from the protection these vendors intended to have when they entered into the original agreements with TSA.

A similar dispute took place in the Family Christian Bookstore Chapter 11 proceeding. That case was slightly different. Whereas in TSA, the Debtor has commenced the lawsuits to determine the consignment interests to be invalid, in the Family Christian Bookstore case, the consignment vendors banded together to prevent Family Christian from selling the consignment inventory. They claimed that the consignments were "true consignments outside the scope of Article 9" because the debtor is "generally known by its creditors to be substantially engaged in selling the goods of others." The consignment vendors claim that because of this exception, neither notification nor UCC filings were necessary to protect the consignment status of these vendors. The Family Christian litigation resulted in a settlement whereby the consignment vendors were paid a portion of the sale price of the consigned inventory so that they received somewhat better treatment than the general unsecured creditors.

This argument is now being discussed in the TSA case by myriad consignment vendors that have been sued. The outcome cannot be predicted at this time although one would hope that a settlement will be reached that will be favorable to consignment vendors.

The moral of this story is consignment vendors must take the necessary steps to protect one's consignment interest or risk diminished treatment. Even if a consignment vendor believes it can convince a court that its business with a customer is that of a "true consignment" a consignment vendor is best served by taking the steps described above to properly notice and perfect its consignment interest and not risk losing the protection and treatment it anticipated by entering into a consignment agreement in the first instance.

Wanda Borges, Esq.
Borges & Associates LLC

Summary

- The UCC is not federal law. Each state adopts the code, and each state may adopt variations to the basic code outlined in the UCC.
- The UCC was created in order to cover every phase of commercial transactions that can involve the sale and payment of goods. Specifically, Article 2 of the UCC applies to sales of transactions in goods.
- Goods are defined as all things, other than money, stocks and bonds, that are movable.
- The UCC distinguishes between merchants and casual or inexperienced sellers by defining merchants as “a person that deals in goods of the kind or otherwise holds itself out by occupation as having knowledge or skill peculiar to the practices or goods involved in the transaction,” which in turn enables merchants to be held to a higher standard.
- It is also important to note, the courts have the right to refuse to enforce contracts that are deemed to contain unfair or unconscionable clauses.

Comprehension Check

How is a **purchase money security interest** established?

Summary Continued…

- A buyer has the right to inspect goods before payment, reject the goods if they fail to conform to the contract or accept in spite of non-conformity. If the goods do not meet the contracted standard, the seller has the right to correct or cure improper delivery. The UCC institutes the concept of **cover**, by which the buyer has the right to purchase substitute goods and recover from the seller the difference between the contracted price and the purchase of replacement goods.
- If the buyer refuses an order that conforms to the contracted standard, the seller also has the right to claim damages against the buyer. The seller must first resell the goods at the best obtainable price and then sue for the difference.
- The UCC provides that the passage of title passes to the buyer when the seller has completely performed their duties concerning physical delivery of goods.
- Risk of loss can be contractually addressed by using commonly accepted shipping terms. The seller has no liability in shipping contracts when goods are given to the carrier. Commonly used shipping contracts:
  - **FOB (Free on Board)**
  - **FAS (Free Alongside)**
  - **CIF (Cost, Insurance and Freight)**
  - **CFR (Cost and Freight)**

Comprehension Check

What requirements must be satisfied for the creation of a security interest?

What is a **security agreement?**

What does a security agreement establish?

At a minimum, a security agreement should contain four essential elements. What are they?

Summary Continued...

- In destination contracts, the seller remains liable until the product is delivered to the specified destination. Common destination contracts include:
  - **FOB destination**
  - **EX-Ship**
  - **No Arrival, No Sale**
- If the seller discovers the buyer is insolvent before making the delivery, the seller has the right to withhold the delivery until the buyer pays cash for the goods and for any previously delivered items that have yet to be paid. This includes goods in transit. Sellers also have the right to demand the return of merchandise from an insolvent buyer within 10 days of the receipt of shipment.
- A warranty is a contractual promise by the seller regarding the quality, character, or suitability of the goods sold, and whenever a seller of goods makes a statement of fact about the goods to a buyer as a part of the transaction, an express warranty is created.
- The four basic types of **implied warranties** include:
  - **An implied warranty of merchantability**
  - **An implied warranty of fitness for a particular purpose**
  - **An implied warranty derived from a usage of trade**
  - **An implied warranty of title**

Comprehension Check

Explain what is meant by the term **perfection by filing.**

Summary Continued…

- Leasing allows the lessee to use valuable assets without making an initial large capital investment.
- If the lessee is discovered to be insolvent, the lessor may refuse the delivery of goods or fully take possession of the goods without judicial process.
- Bulk transfers create special problems for businesses. Therefore, Article 6 was created within the UCC to protect creditors from merchants who are debtors from selling their entire inventory for less than it is worth.
- The UCC lists requirements for the transfer of goods, which if not fulfilled, forfeits the rights to ownership of the goods. If this occurs, a creditor must move quickly to assess how much time will elapse before the sale, a description of the property being sold, the property's value, any other creditors and the amount due to them, and whether debts should be paid in full.

Comprehension Check

What is **consignment?**

Summary Continued…

- Business could not exist without laws permitting secured transactions. Article 9 of the UCC contains the law of secured transactions in personal property and fixtures.

- The UCC does not apply to liens on real estate, aircraft and certain vessels, wages, or certain types of insurance claims. Motor vehicles may be subject to UCC, but perfection is subject to other law.
- A security interest must be classified under the following categories:
  - Accounts and general intangibles
  - Deposit accounts
  - Goods
  - Instruments
  - Investment property
  - Chattel paper
- It is vital that a creditor determines the primary use of the collateral, because when handled by different individuals the item may change classification.

Comprehension Check

List three elements that should be included in a UCC financing statement.

As a general rule, how long is a filing valid?

Comprehension Check

List at least five "events of default."

Summary Continued…

- The following requirements are needed to create a **security interest**:
  - **Creditor provided value to the debtor**
  - **Debtor has rights to the collateral and the power to transfer rights to the secured party**
  - **There is a valid security agreement that describes the collateral in which the creditor is granted security interest**
- At a minimum, a **security agreement** should contain:
  - **Identification of parties**
  - **Granting clause**
  - **Collateral description**
  - **Debtor's warranties, covenant and agreements**
- Perfection is necessary to ensure the secured party's right to collateral given that other parties may have interest in the collateral. Generally, a security interest is perfected either through the taking of possession or control of the collateral or the filing of a financing statement under the UCC. Perfection can also occur if both steps are taken.
- A **UCC financing statement** should contain:
  - **Name of the debtor**
  - **Name of the secured party or its representative**
  - **Description of collateral**
- Priority rules can vary, but the longstanding rule is that the first secured party to file a UCC financing statement or otherwise perfect its security interest has priority over competing secured parties. The rules often vary depending on the category of collateral.

Comprehension Check

How is **priority** established?

Comprehension Check

What is a secured party entitled to under collection rights?

Summary Continued…

- For **purchase money security interests,** it is important to note that a security interest does not qualify as a purchase money security interest if the debtor acquires the property on unsecured credit terms, and subsequently creates a security interest to secure the purchase price. However, if done correctly, the secured party has superpriority status over existing perfected security interests.
- When a **merger or successor debtor** occurs, a creditor should research whether the UCC financial statement has become invalid and should be refiled. This commonly occurs if the debtor is located or changes states.
- The whole point of having a security interest in the debtor's assets is the secured party's ability to dispose of those assets toward payment of the debt if default occurs.
- If a debtor is in default, the secured party may pursue the following **enforcement remedies**:
  - **Collection rights**
  - **Nonjudicial repossession of collateral**
  - **Judicial foreclosure of Article 9 interests**
  - **Disposition of collateral after default**
  - **Strict foreclosure**
  - **Application of proceeds of disposition**

Principles of Business Credit

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