VENDOR-MANAGED INVENTORY AND CONSIGNMENTS

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VENDOR-MANAGED INVENTORY
THE BASICS

- VMI involves close strategic relationships between vendors and their customers by putting the vendor in charge of the customer's inventory

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VENDOR-MANAGED INVENTORY
THE BASICS

- VMI is the process whereby a supplier or vendor manages and replenishes inventory at a customer's location at the levels required by the customer
- The customer shares data such as point of sale (POS) data, customer forecasts, current inventory levels, and inventory target levels, which will be used to develop an appropriate distribution plan by the vendor
- The vendor is usually the supplier, a manufacturer or a distributor

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VENDOR-MANAGED INVENTORY
KEY BENEFITS

- Improved alignment of inventory with customer demand
  - Allows supplier to dynamically adjust inventories in response to customer demand
  - Improves overall supply chain responsiveness to seasonal changes, special promotions, and new initiatives
  - By smoothing out the effects of demand variability, suppliers can better coordinate manufacturer lead times
  - Suppliers can carry a leaner inventory of finished goods
  - Leads to lower carrying costs and reduced disruptions from stock-outs and other inefficiencies

VENDOR-MANAGED INVENTORY
KEY BENEFITS

- Streamlined processes and lower costs
  - Because supplier controls customer inventory in a VMI relationship, supplier can achieve significant efficiencies
  - Ordering process is typically based on more accurate and up-to-date data, which allows for cost savings by achieving VMI benefits:
    - Reducing frequency of costly last-minute orders
    - Reducing overall number of orders
    - Reducing returns due to product replacements

VENDOR-MANAGED INVENTORY
KEY BENEFITS

- Improved data insight
  - VMI program takes supplier's data analytics to new level of sophistication that feeds into its entire operation beyond the warehouse
    - Better understanding of actual demand helps sales managers improve performance and develop stronger relationships with customers
    - As customers share more and better data, supplier's insights into its marketplace often expand in valuable ways

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VENDOR-MANAGED INVENTORY
KEY BENEFITS

- Closer collaboration with customers
  - Effective VMI program develops through cooperation
    - Suppliers who use VMI can enhance relationships with customers
      - Customers gain significant competitive advantage thanks to the superior service on-time delivery that VMI enables
    - Customers quickly recognize that they can leverage their supplier's VMI program to improve results, both for day-to-day operations and for special programs

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VENDOR-MANAGED INVENTORY
KEY BENEFITS

- Improved sales figures
  - As supplier develops a better understanding of actual customer demand through its VMI process, it becomes a better partner to its customers and therefore may be more likely to see increased sales
  - By encouraging greater transparency and communication, supplier can better respond to its customers' conditions and future plans, ultimately helping customer-supplier relationship grow in more efficient and predictable ways

VENDOR-MANAGED INVENTORY
KEY BENEFITS

- Proprietary / private-label inventory problem
  - Long lead time requirements can lead to problems for suppliers if buyer changes its requirements or becomes financially distressed
    - Supplier could be stuck with a lot of useless inventory
  - VMI can minimize this exposure

VENDOR-MANAGED INVENTORY
VMI AGREEMENT AS EXECUTORY CONTRACT

- A VMI agreement may be an executory contract if customer files bankruptcy
  - May be subject to
    - Assumption
    - Assumption and assignment to buyer
  - If agreement is a requirements contract, customer might assume if
    - Goods are critical and supplier cannot quickly or easily be replaced
    - Contract price for goods is below market

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VENDOR-MANAGED INVENTORY VS. CONSIGNMENT

- VMI and consignment <u>have nothing to do with one another</u>
  - VMI is where vendor manages customer's inventory supply
  - Consignment relates to <u>ownership</u> of the inventory
  - Neither is dependent upon the other

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VENDOR-MANAGED INVENTORY VS. CONSIGNMENT

- You can have a VMI relationship that is not a consignment
- You can have a consignment that is not a VMI relationship
- You can have a relationship that is both VMI and consignment

CONSIGNMENTS

BUT FIRST………

- Before discussing consignments, let's gain an understanding of…………..

PURCHASE MONEY SECURITY INTEREST

- A purchase money security interest ("PMSI") has priority over a secured lender's lien if the PMSI is properly and timely perfected
- Gives seller of goods a security interest in the goods being sold and the proceeds of sale of those goods
- If done properly, seller's security interest in the goods being sold and the proceeds of those goods **comes ahead of the secured lender's lien**
  - This is so even through secured lender perfected its lien first
  - PMSI gives seller of goods a superpriority lien

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PURCHASE MONEY SECURITY INTEREST
HOW TO ASSERT A PMSI PROPERLY

- First, must have language where customer grants seller a purchase money security interest
  - Can be included in:
    - Purchase order
    - Supply contract
    - Terms and conditions

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PURCHASE MONEY SECURITY INTEREST

HOW TO ASSERT A PMSI PROPERLY

- Must take steps to perfect PMSI in inventory
  - File a UCC-1 financing statement
  - Send notice to any secured party with a security interest in those goods
    - Conduct lien search to ascertain other secured parties
    - Notice must state that seller has or expects to acquire a purchase money security interest in inventory of the debtor and describes the inventory
- UCC-1 filing and notice to other secured parties must be done:
  - Before goods are delivered to customer for inventory
  - Within 20 days after delivery for goods other than inventory (i.e., equipment)

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PURCHASE MONEY SECURITY INTEREST

HOW TO ASSERT A PMSI PROPERLY

- Make sure that customer does not have prohibition on PMSI's in its loan documents
  - If there is a prohibition, make sure that customer obtains lender's consent first
- Effect of customer's failure to obtain lender's consent where required
  - No effect on your PMSI
  - But could be a default under loan documents that lender will call, causing a bigger problem for your customer

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PURCHASE MONEY SECURITY INTEREST
HOW TO ASSERT A PMSI PROPERLY

- How to “sell” PMSI to lender where lender’s consent is required
  - You will not sell goods without PMSI, so lender will not have those goods as part of its collateral either way
  - Should consent to PMSI because your goods on the shelf drives foot traffic and enhances borrower’s value

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PURCHASE MONEY SECURITY INTEREST
ENFORCEMENT

- Foreclosure option
  - In the event of non-payment, a PMSI gives you, as a secured party, the option to foreclose
  - Allows secured party to sell collateral and collect proceeds of sale to be applied to unpaid debt

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PURCHASE MONEY SECURITY INTEREST

EFFECT IN BANKRUPTCY

- If customer files bankruptcy:
  - PMSI gives you, as PMSI secured party, superior rights to any other creditor, secured or unsecured, with respect to your collateral
    - What does this mean?
      - Whether customer reorganizes or liquidates in bankruptcy, you get paid the value of your collateral ahead of other creditors
      - If you did not have a PMSI, you would be paid as a general unsecured creditor and recovery, in most cases, is much lower
  - ***Proactive Pointer:*** You must document your PMSI properly, including the UCC-1 filing, in order to have this superpriority!

CONSIGNMENTS

- In a consignment arrangement, seller retains ownership of goods
- Consigned goods are delivered to "consignee"
- When consignee sells goods, consignee remits a percentage of sale proceeds to seller and retains remainder
- Seller-consignor does not get paid up front as in a true sale, but offers a measure of protection when buyer-consignee experiences financial difficulty

CONSIGNMENTS

- Consignment treated the same as a purchase money security interest
- UCC § 9-103(d)
  - The security interest of a consignor in goods that are the subject of a consignment is a purchase-money security interest in inventory.
- This means that, if done properly, a seller-consignor has rights that are superior to buyer-consignee's secured lender

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CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Two required steps to properly document a consignment of inventory:
  - Must file a UCC-1 financing statement (same as a secured creditor)
    - Check the consignment box to indicate a consignment rather than a security interest
  - Must send notice to other secured creditors
    - Lien search must be done to determine existing secured creditors with a lien on inventory entitled to notice
    - Send notice to all secured creditors with a lien on inventory

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CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Timing
  - Both financing statement **and** notices to secured creditors **must be sent before any consigned goods are delivered**
  - Failure to do so will result in consignor's rights in any goods delivered before both of these steps are taken being subordinate to secured lender with lien on inventory

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CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Requirement to file a financing statement is found in UCC § 9-317(e)
  - ….[I]f a person files a financing statement with respect to a purchase-money security interest before or within 20 days after the debtor receives delivery of the collateral, the security interest takes priority over the rights of a buyer, lessee, or lien creditor which arise between the time the security interest attaches and the time of filing.
- But for inventory, disregard the idea to file within 20 days after delivery of the goods

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CONSIGNMENTS

HOW TO DOCUMENT A CONSIGNMENT PROPERLY

- Notice requirement and timing requirement to perfect (i.e., file financing statement) before delivery of consigned inventory is found in UCC § 9-324(b)
  - ….[A] perfected purchase-money security interest in inventory has priority over a conflicting security interest in the same inventory…and [] also has priority in identifiable cash proceeds of the inventory to the extent the identifiable cash proceeds are received on or before the delivery of the inventory to a buyer, if:
    - (1) the purchase-money security interest is perfected when the debtor receives possession of the inventory;
    - (2) the purchase-money secured party sends an authenticated notification to the holder of the conflicting security interest;
    - (3) the holder of the conflicting security interest receives the notification within five years before the debtor receives possession of the inventory; and
    - (4) the notification states that the person sending the notification has or expects to acquire a purchase-money security interest in inventory of the debtor and describes the inventory.

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CONSIGNMENTS

RIGHTS OF CONSIGNOR

- A true consignment arrangement that is properly documented prevents security interest of consignee's secured lender from attaching to consignor's inventory

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CONSIGNMENTS
TRAPS FOR THE UNWARY

- The *Sports Authority* example
  - Appoximately 160 consignment vendors
    - Only approximately 40 of those filed financing statements and sent required notice to secured creditors
    - Of those 40, only <u>three</u> filed financing statements sooner than 90 days before Sports Authority filed bankruptcy
      - Those filed within 90 days before bankruptcy were avoidable as preferences, leaving those consignment vendors in the same position as those who did not file financing statements at all

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CONSIGNMENTS
TRAPS FOR THE UNWARY

- Lessons from *Sports Authority*
  - Make sure to file a financing statement and send notice of consignment arrangement to secured creditors
    - Make sure to do this <u>before</u> shipping any consigned goods
      - Failure to do so in Sports Authority resulted in
        - » Secured lenders' liens attaching to consigned goods
        - » Secured lenders having priority over consignors
        - » All but the three consignors who properly documented and perfected their consignment arrangements receiving far less than they would have if done properly

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QUESTIONS

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