

Consignment Without a UCC Filing? What Secured Lenders Know Can Hurt Them



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A trade creditor can mitigate the risk of dealing with a financially distressed customer by entering into a consignment agreement with its customer. A creditor that "dots its i's and crosses its t's" and satisfies all of the requirements for consignment contained in Article 9 of the Uniform Commercial Code ("UCC") obtains a first and prior interest in its consigned goods. On the other hand, a creditor that fails to satisfy the UCC's requirements for consignment risks losing its superior interest in its consigned goods and being relegated to holding a low priority general unsecured claim.

That said, certain creditors that fail to follow UCC Article 9's consignment requirements can invoke a recent decision of the United States Bankruptcy Court in Delaware in the Sports Authority Chapter 11 case, *TSA Stores, Inc. v. Performance Apparel Corp. (In re TSAWD Holdings, Inc.)*, as support for enforcing their consignment rights. The bankruptcy court held that a creditor who had allowed its UCC financing statement to lapse still retained a superior interest in its consigned goods that prevailed over the blanket security interest of Sports Authority's secured lenders. The court relied on the secured lenders' actual knowledge of the consignment arrangement when the lenders had made their loans to Sports Authority.

What Is a Consignment?

In a consignment transaction, the seller, known as the consignor, retains title to the goods that were delivered to a prospective purchaser, the consignee. The consignment agreement between the consignor and

consignee contains the terms of the consignment arrangement, that, if the agreement is properly drafted, should protect the consignor's interest in its consigned goods. The consignee holds the consigned goods for sale or converts the goods to a finished product for sale, and only takes title to the consigned goods when it uses or sells the goods. The consignor frequently issues an invoice containing the payment terms to the consignee after the consignee's reported sale or use of the goods. If the consignee cannot sell or use the goods, the consignee can return the goods to the consignor as long as this right is granted under the consignment agreement.

UCC Article 9 governs many consignment transactions. UCC Section 9-102(a)(20) defines a consignment as a transaction in which a person delivers goods to a merchant for purposes of sale, and (a) the merchant deals in goods of that kind under a name other than the name of the person making delivery, is not an auctioneer and is not generally known by its creditors to be substantially engaged in selling the goods of others; (b) the goods must have a value of at least \$1,000.00 at the time of delivery; (c) the goods are not consumer goods immediately before delivery; and (d) the transaction does not create a security interest.

According to UCC Section 1-201(37), a security interest includes a consignment subject to UCC Article 9. UCC Section 9-319(a) also states that a consignee acquires all of the consignor's rights in the consigned goods when the consignor's interest is not perfected. A consignor can perfect its interest

in its consigned goods by filing a UCC financing statement, describing the goods in the correct jurisdiction. And under Article 9, a consignor could file a UCC on its own, without the consignee's signature, as long as the consignee executes or authenticates a consignment agreement that describes the consigned goods. The consignor uses the same UCC financing statement form that a secured creditor uses in perfecting a security interest in personal property collateral. A consignor that fails to properly file a UCC financing statement risks losing its prior rights in the consigned goods to those creditors of the consignee that obtain judicial liens and security interests in the goods. Since a bankruptcy trustee and debtor-in-possession are considered judicial lien creditors, they would similarly enjoy priority over an unperfected consignor.

A consignor must do more than merely file a UCC financing statement to obtain a priority in its consigned goods over the rights of the consignee's creditor that obtained a perfected blanket security interest in the consignee's inventory prior to the consignment arrangement. UCC Section 9-103(d) states that a consignor has a purchase money security interest in its consigned goods. As such, a consignor has priority over a creditor with prior blanket security interest in the consignee's inventory if the consignor satisfies all of the following requirements for a valid purchase money security interest contained in UCC Section 9-324: (a) perfection of the consignment interest prior to the consignee's possession of the goods; (b) delivery of a notice to the holders of conflicting security interests in the consignee's inventory stating that the consignor has, or expects to, acquire a consignment interest in the goods and describing the goods; and (c) receipt of the notice by the holders of conflicting security interests in the goods.

UCC Article 9 is not the governing law for all consignment transactions. Consignments that do not satisfy the requirements of UCC Section 9-102(a)(20) are "true consignments" governed by state law. True consignments do not require a consignor to file a UCC financing statement and provide notice of its consignment interest to secured creditors with a prior perfected blanket security interest in the consignee's

inventory to retain prior rights in the consigned goods.

A consignor that seeks to prove that it has a true consignment and enhanced priority status in its consigned goods, without the need to satisfy UCC Article 9's requirements, must satisfy the high burden of demonstrating that the consignee is generally known by its creditors to be substantially engaged in selling the goods of others. The applicability of this exception was at issue in the *Sports Authority* case. More to the point, the *Sports Authority* court addressed whether the consignor is excused from complying with Article 9 where the secured lenders had actual knowledge of the consignment arrangement when they had made their loans to Sports Authority.

The Facts of the *Sports Authority* Case

On March 2, 2016, (the "Petition Date") Sports Authority, a national retailer of sporting goods and active apparel, filed its Chapter 11 cases in the United States Bankruptcy Court in Delaware. Sports Authority had developed a program for vendors to sell goods on consignment terms to Sports Authority by entering into "pay by scan" agreements with Sports Authority. Performance Apparel Corporation ("PAC") was one of the first vendors to sell goods on consignment to Sports Authority. PAC had filed a UCC-1 financing statement with respect to its consigned goods on Aug. 28, 2009, and gave notice of the consignment arrangement to Bank of America ("BOA"), the agent for Sports Authority's term loan lenders. However, PAC had failed to file a continuation statement (which was required to continue the perfection of its consignment interest), causing PAC's UCC-1 filing to lapse in 2014 and leaving PAC with an unperfected interest in its consigned goods.

Prior to the Petition Date, Sports Authority had borrowed approximately \$1.1 billion from various lenders. The loans included a \$650 million asset-based revolving credit facility and a \$300 million term loan. BOA was the administrative agent under both loans. The term loan, which was at issue in the *Sports Authority* case, was secured by, among other assets, a second priority

security interest in Sports Authority's inventory and other assets that also served as collateral securing payment of the revolver. The term loan security interest was created by Sports Authority's execution of a security agreement that included Sports Authority's inventory as collateral, and was perfected by the filing of UCC-1 financing statements in the necessary jurisdictions. On Dec. 15, 2015, Wilmington Savings Fund Society ("WSFS") replaced BOA as the term lenders' agent. WSFS asserted a secured claim against Sports Authority for the remaining balance of the term loan in the principal amount of approximately \$276.7 million when Sports Authority had filed its Chapter 11 case.

On the Petition Date, approximately 11-12% of Sports Authority's total inventory was subject to various consignment arrangements. Early in the Chapter 11 case, the consignors had disputed Sports Authority's right to pledge or sell their consigned goods. The bankruptcy court approved Sports Authority's sale of consigned goods in the ordinary course of business as long as Sports Authority had complied with its pre-petition consignment agreements. The order preserved WSFS' right to recoup payments that Sports Authority had made to the consignors from the sale of consigned goods in the event the court later ruled that WSFS had prior rights in the consigned goods. By the end of July 2016, Sports Authority had returned or sold all of the goods it had received on consignment from PAC, which had an "extended cost" of \$1,586,446 as of the Petition Date, and paid the proceeds to PAC according to the terms of PAC's consignment agreement with Sports Authority.

On March 15, 2016, Sports Authority commenced an adversary proceeding against PAC. Sports Authority sought a declaratory judgment regarding the priority of PAC's interest in its consigned goods. WSFS intervened as a plaintiff in the adversary proceeding and sought (1) a declaration that WSFS' (and the term lenders') perfected security interest in PAC's consigned goods had priority over PAC's unperfected consignment interest in the goods and (2) judgment against PAC to recover all proceeds PAC had received from Sports Authority's prior sale of PAC's consigned goods.

On May 18, 2018, the parties filed cross-motions for summary judgment regarding their respective interests in the consigned goods and their proceeds. WSFS argued that it (and the term lenders) had a blanket perfected security interest in Sports Authority's inventory, including the consigned goods, pursuant to the term loan credit agreement and security agreement and its filed UCC-1 financing statements in the relevant jurisdictions. WSFS asserted that PAC's consignment interest was not perfected on the Petition Date because PAC's previously filed UCC-1 financing statement had lapsed due to PAC's failure to file a UCC continuation statement. As a result, WSFS' (and the term lenders') prior perfected security interest had priority over PAC's unperfected interest in the consigned goods pursuant to Section 9-322(a) of the UCC.

PAC argued that the lapse of its UCC filing was not dispositive because its consignment arrangement was a true consignment and, therefore, was not subject to UCC Article 9's filing requirements. PAC relied on the term lenders' actual knowledge of PAC's consignment arrangement prior to making the term loan.

The Court's Granting of Summary Judgment in PAC's Favor

The bankruptcy court held that PAC's interest in its consigned goods was superior to WSFS' and the term lenders' blanket security interest in the goods, despite PAC's failure to continue its UCC financing statement and thereby continue the perfection of its consignment interest under UCC Article 9. The court relied on UCC § 9-102(a)(20), that a consignment is not subject to Article 9's priority rules if a consignor can prove that the consignee's creditors generally knew that the consignee was substantially engaged in selling consigned goods. The court also agreed with the holdings of other courts that Article 9's priority rules do not apply if a secured creditor had actual knowledge that its borrower held goods on consignment when the security interest was granted. As the court explained, the UCC's filing requirements are designed to protect creditors from "hidden liens"—such as the "secret liens" of unperfected consignors. If a secured lender knows about a particular

consignment arrangement when it had made its loan to the debtor, then the consignor's interest is no secret to the lender, and it would not offend the purpose of the UCC Article 9 to afford the unperfected consignor priority over the secured lender's perfected blanket security interest in the consignee's inventory.

The bankruptcy court concluded that the term lenders had actual knowledge of PAC's consignment arrangement when they had made their loan to Sports Authority. The court relied on the fact that PAC was listed as a Permitted Lien in a schedule to the term loan agreement. The court also relied on the testimony of WSFS' witness that BOA and all of the term lenders had known that PAC had a perfected interest in the consigned goods when they had made the term loan. As a result, the court held that PAC's arrangement with Sports Authority was a true consignment and was not governed by UCC Article 9. PAC did not have to continue its UCC filing, and, therefore, despite losing its perfected status under the UCC, PAC's consignment interest was superior to WSFS' (and the term lenders') blanket security interest in the consigned goods.

Conclusion

The Delaware bankruptcy court's recent decision in the *Sports Authority* case is a win for unperfected consignors to the extent they can prove the debtor's secured creditors knew about the debtor's existing consignment arrangements when the secured creditors had entered into loan agreements with the respective consignees. That said, proving actual knowledge may not always be as simple as it was in this *Sports Authority* case where PAC's consignment interest was explicitly acknowledged in the term loan credit agreement. Nonetheless, the court's decision suggests that an unperfected consignor can prevail over a secured lender with actual knowledge of the consignment interest at the time the term loan was made.

Only time will tell how broad of an impact this *Sports Authority* decision will have. The courts will have to grapple with the issue of what constitutes actual knowledge of an existing consignment arrangement that would subordinate a lender's prior perfected

secured interest in consigned goods to an unperfected consignor. The facts in *Sports Authority* were easy—the term loan agreement referenced PAC's consignment interest as a permitted lien and PAC had an existing UCC filing referencing its consigned goods when the term loan was extended to Sports Authority. Will a court consider a lender to have actual knowledge if it learns of a consignment arrangement while conducting diligence regarding the consignee's business prior to making its loan?

Or, will the impact of this *Sports Authority* decision be somewhat limited? It is worth noting that the same bankruptcy judge who issued this *Sports Authority* decision recently *rejected* another unperfected consignor's argument that it did not have to file a UCC financing statement to have priority over the blanket security interest of Sports Authority's secured lenders in a ruling issued in a companion litigation, *TSA Stores, Inc. v. M J Soffe, LLC* ("*Soffe*"). In the *Soffe* decision, the court concluded there was insufficient evidence in the record to demonstrate that the lenders had actual knowledge of that consignment arrangement.

Frankly, a consignor's best bet is to avoid going through the very costly route of litigating to obtain answers to these questions. A consignor would be wise to follow the applicable requirements for perfection and priority under UCC Article 9 to avoid the cost and uncertainty inherent in litigating whether its consignment arrangement is governed by UCC Article 9's requirements.

This is not the end of the story. WSFS has filed an appeal from the bankruptcy court order granting relief in favor of PAC. Stay tuned for further developments! 

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