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Consignment the Wrong Way: Recovery Still Possible

Trade creditors enter into consignment arrangements with their financially distressed customers to increase the likelihood of payment of their claims. The best practice for a consignment goods seller, known as the consignor, is to satisfy all the requirements contained in Article 9 of the Uniform Commercial Code (“UCC”) governing consignments. A consignor that “dots its i’s and crosses its t’s” by satisfying these requirements obtains a first and prior interest in its consigned goods. A noncompliant consignor risks being treated as a general unsecured creditor.

However, consignors that fail to comply with UCC Article 9 can take much comfort from the 2017 decision of the United States Bankruptcy Court in Delaware, in *In re TSAWD Holdings, Inc.*, formerly known as Sports Authority. The bankruptcy court refused to grant judgment in favor of Sports Authority’s secured lender, Wilmington Savings Fund Society, FSB (“WSFS”), which had sought a declaration that it had a prior perfected security interest in Sports Authority’s inventory, senior to the rights of a consignor that had failed to file a UCC financing statement describing its consigned goods. The court denied WSFS’ motion and permitted the litigation to continue. The court found an issue of fact existed over whether the consignment arrangement was a true consignment not governed by UCC Article 9, and not requiring the consignor to file a UCC financing statement.

The agreement should contain all of the necessary terms and conditions to protect a consignor’s interest in its consigned goods.

This decision opens the door for consignors that fail to follow UCC Article 9’s consignment requirements to obtain at least some recovery on their consignment claims.

What Is a Consignment?

In a consignment transaction, the seller is the consignor, and the prospective purchaser is the consignee. The consignor retains title to the goods after delivering them to the consignee. The consignee then holds the consigned goods for sale, or uses the goods by converting them to a finished product for sale. Title to the consigned goods passes to the consignee when it uses or sells the goods. The consignor usually issues an invoice



to the consignee containing the payment terms after the consignee’s reported sale or use of the goods. If the consignee cannot sell or use the goods, the consignee can often return them to the consignor.

The terms of a consignment arrangement are frequently governed by a written agreement between the consignor and consignee. The agreement should contain all of the necessary terms and conditions to protect a consignor’s interest in its consigned goods.

UCC Article 9 governs most 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 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.

UCC Section 1-201(37) defines a security interest to include a consignment subject to UCC Article 9. UCC Section 9-319(a) states that if a consignor’s interest in the goods is not perfected, a consignee acquires all of the consignor’s rights in the consigned goods in determining the rights of creditors of, and purchasers for value of goods from, a consignee. That means a consignor should file a UCC financing statement, describing the consigned goods, in the correct jurisdiction in order to maintain a protected interest in the goods. And under Article 9, a consignor could file a UCC on its own, without the consignee’s signature, as

long as there is a consignment agreement executed or otherwise authenticated by the consignee that describes the consigned goods. A consignor uses the same UCC financing statement form that a secured creditor uses in perfecting a security interest in personal property collateral. A consignor could identify the existence of a consignment transaction in the UCC financing statement. A consignor that fails to properly file a UCC financing statement risks other creditors of the consignee obtaining judicial liens and security interests in the goods with priority over an unperfected consignor. 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 interest in the consigned goods over the rights of the consignee's secured creditor with a prior blanket security interest in the consignee's inventory. UCC Section 9-103(d) states that a consignor has a purchase money security interest in its consigned goods. As such, a consignor would have 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 (by filing a UCC financing statement); (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. Otherwise, a consignor falling behind a creditor with a prior perfected blanket security interest in the consignee's inventory.

Consignments that do not satisfy the requirements of UCC Section 9-102(a)(20) are governed by state law. They are true consignments and do not require the 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. A consignor that seeks to exclude its consignment from the UCC and still enjoy enhanced priority status in its consigned goods must prove that the consignee is generally known by its creditors to be substantially engaged in selling the goods of others. The applicability of this exception, which is very difficult to prove, was at issue in the *Sports Authority* case.

The Facts of the *Sports Authority* Case

On March 2, 2016, (the "Petition Date") Sports Authority had filed its Chapter 11 cases in the Bankruptcy Court in Delaware. Sports Authority had marketed and sold sporting goods and active apparel for retail stores located across the United States and Puerto Rico under the name Sports Authority. MJ Soffe, LLC ("Soffe") had sold sporting goods and athletic apparel to Sports Authority for resale pursuant to a Pay by Scan Agreement that was a consignment arrangement. Soffe did not file a UCC financing statement describing the consigned goods. The consigned goods in dispute on the Petition Date consisted of approximately \$5,421,528 of goods that

Soffe had delivered pre-petition to Sports Authority (the "Disputed Consigned Goods").

WSFS was Sports Authority's secured lender. WSFS asserted a secured claim in the principal amount of approximately \$276.7 million against Sports Authority on the Petition Date pursuant to a pre-petition term loan credit agreement previously entered into between Sports Authority and WSFS. WSFS asserted that Sports Authority had granted WSFS a blanket security interest in all of Sports Authority's inventory pursuant to a pre-petition term loan security agreement. WSFS perfected its security interest by filing a UCC financing statement.

On March 16, 2016, Sports Authority had commenced adversary proceedings against its consignors, including Soffe (the "Adversary Proceedings"). Sports Authority sought declaratory relief with respect to the competing claims of WSFS and the consignors, including Soffe, in all consigned goods, including the Disputed Consigned Goods.

On May 3, 2016, the bankruptcy court authorized Sports Authority to sell its consigned goods in the ordinary course of business as long as Sports Authority had complied with its pre-petition consignment agreements. That included remitting a portion of the sales proceeds to Sports Authority's consignment vendors, including Soffe. Sports Authority had agreed to this procedure only after the court had refused to permit Sports Authority to sell the Disputed Consigned Goods and the goods of all other consignors until the court could determine the competing interests of WSFS and the consignors, including Soffe, in the consigned goods and their proceeds in the Adversary Proceedings. The court's order also stated that the proceeds paid to Soffe (and the other consignors that did not file UCC financing statements), together with interest, were subject to disgorgement.

WSFS intervened in the Adversary Proceedings, including the litigation involving Soffe. WSFS filed a complaint against Soffe seeking a declaration that WSFS had a perfected security interest in the Disputed Consigned Goods that was senior to Soffe's interest, and disgorgement of all proceeds Soffe had previously received from Sports Authority's sale of the Disputed Consigned Goods. Soffe filed an answer to WSFS' complaint and a counterclaim for a declaration that WSFS' security interest did not attach to the Disputed Consigned Goods and that to the extent WSFS had a security interest in the Disputed Consigned Goods, which Soffe had disputed, WSFS' security interest was subordinate to Soffe's consignment interest in the goods.

WSFS filed a motion for partial judgment on the pleadings. WSFS sought a declaration that WSFS had a perfected security interest in the Disputed Consigned Goods and all proceeds of the sale of the goods that was senior to Soffe's consignment interest, as well as disgorgement by Soffe of the proceeds Soffe had received. WSFS argued that its blanket security interest in Sports Authority's inventory attached to the Disputed Consigned Goods and had priority over Soffe's consignment interest in the goods. WSFS claimed priority sta-

tus based on its prior perfected security interest in the Disputed Consigned Goods and Soffe's failure to file a UCC financing statement covering these goods.

Soffe disputed WSFS' asserted superior interest in the Disputed Consigned Goods. Soffe argued that its consignment arrangement was not covered by the UCC because Sports Authority was generally known by its creditors to be substantially engaged in selling the goods of others and WSFS had actual knowledge of Soffe's consignment arrangement with Sports Authority.

WSFS responded that Soffe was precluded from arguing that its consignment arrangement was not covered by UCC Article 9. WSFS relied on the provision in the Pay By Scan Agreement that the "arrangement shall qualify as a consignment under Section 9-102(a)(20) of both the Colorado and Delaware versions of the UCC."

The Court's Denial of WSFS' Motion for Partial Judgment on the Pleadings

The court refused to grant the relief sought by WSFS. The court found the existence of a disputed issue of fact over whether the Pay By Scan Agreement was a consignment governed by UCC Article 9. The court disregarded the Pay By Scan Agreement provision that the "arrangement shall qualify as a consignment under Section 9-102(a)(20) [of the UCC]" because it was inconsistent with the UCC's requirements. This provision implicitly treated Sports Authority as a "merchant", which is a defined term under the UCC.¹ If Sports Authority was generally known to be selling the goods of others or WSFS knew that Soffe was selling the Disputed Consigned Goods on consignment terms to Sports Authority, as Soffe had contended, then Sports Authority was not, in fact, a "merchant" and the Pay By Scan Agreement had impermissibly changed the UCC definitions of consignment and merchant. Similarly, the court refused to find that WSFS had a perfected security interest in the Disputed Consigned Goods and their proceeds that was superior to Soffe's unperfected consignment interest, pending resolution of the dispute over the applicability of the UCC to the consignment arrangement.

Conclusion

A consignor's rights to its consigned goods, even in the absence of a UCC filing, will likely continue to be hotly contested in bankruptcy cases. The lesson learned from the *Sports Authority* case is that a consignor should take all of the required steps under UCC Article 9 to obtain a valid, perfected and priority interest in its consigned goods.

However, the court's decision in the *Sports Authority* case leaves the door open for consignors that fail to "dot their i's and cross their t's" to seek recovery on their consignment claims. Many consignors that failed to file UCC financing statements had settled with WSFS and Sports Authority. Most of the settling consignors received between 25% to 40% of the proceeds of the sales of their consigned goods payable under their consignment agreements. Some of the consignors received as much as 45% to approximately 50% of the proceeds of the sales of their consigned goods due under their consignment agreements.

Soffe did not settle its claim and the litigation involving Soffe's Disputed Consigned Goods is still pending so this story is far from over! But one thing is clear—Soffe could be incurring significant attorneys' fees litigating over its consignment claim that might have been avoided had Soffe followed UCC Article 9's consignment requirements. ■

¹ UCC Section 2-104 defines a "merchant" as "...a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill."

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