

Unperfected Consignors Be Warned: You Could Lose Your Goods and Proceeds



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Trade creditors enter into consignment agreements with their customers for various reasons. Some do so as a matter of standard practice in industries where a consignment arrangement will help the customer avoid burdensome working capital needs due to the high costs associated with the relevant product (such as petroleum). Others use consignment arrangements as a means of protecting themselves when supplying goods to financially distressed customers. In any event, a consignment seller (known as a consignor) provides goods to its customer (known as a consignee) with the expectation that the consignor retains an ownership interest—and, therefore, will maintain a priority interest—in the consigned goods.

A consignor should “dot its i’s and cross its t’s” by satisfying all of the requirements contained in Article 9 of the Uniform Commercial Code (“UCC”) governing consignments as a matter of best practice. This will ensure that the consignor will enjoy prior rights to its consigned goods over the rights of a secured lender with a blanket security interest in the consignee’s

goods and the rights of a bankruptcy trustee as a judgment lien creditor under the Bankruptcy Code. However, a consignor that fails to satisfy the UCC’s perfection requirements risks being treated as a general unsecured creditor in the event the consignee files for bankruptcy.

That horror scenario for consignors came to pass in the recent decision of the United States Court of Appeals for the Ninth Circuit (the “Ninth Circuit”) in *In re Pettit Oil Company*. The Ninth Circuit held that a bankruptcy trustee had superior rights over a noncompliant consignor’s rights in, and upheld the trustee’s avoidance of the consignor’s interest in, both consigned goods and their proceeds.

What Is a Consignment?

In a consignment transaction, the seller is the consignor, and the purchaser is the consignee. The consignor retains title to the goods delivered to the consignee. The consignee then holds the consigned goods for sale, or converts consigned raw materials to 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 agreed payment terms after the consignee’s reported sale or use of the goods. If the consignee cannot sell or use the goods after a fixed period of time agreed to between the consignor and consignee, the consignee can frequently 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 consignee 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.

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 if a consignor does not perfect its interest in the consigned goods. That means a consignor should file a UCC financing statement adequately 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. In addition, according to UCC Section 9-324, a consignor seeking a prior interest in the consigned goods over the rights of a secured creditor with a prior perfected blanket security interest in all of the consignee's inventory must provide notice of its consignment interest to the secured creditor.

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 either file a UCC financing statement or follow UCC Article 9's other requirements for obtaining a priority interest in the consigned goods. 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. This is usually not easy to prove and frequently results in costly and time-consuming litigation.

A consignor whose consignment arrangement is governed by UCC Article 9 and 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 under the Bankruptcy Code, they have the power under Bankruptcy Code Section 544(a)(1) to avoid unperfected security and consignment arrangements and recover consigned goods and their proceeds for the benefit of the bankruptcy estate. As illustrated by the Ninth Circuit's *Pettit Oil* decision, that resulted in the consignor's loss of its consigned goods and all proceeds from their sale.

The Facts of the *Pettit Oil* Case

On November 25, 2013, Pettit Oil Company ("Pettit Oil") filed a Chapter 11 bankruptcy case in the United States Bankruptcy Court for the Western District of Washington. Pettit Oil was a distributor of bulk petroleum products that operated "card lock" sites where commercial customers could purchase fuel products using access cards. In 2013, Pettit Oil entered into a consignment agreement with IPC (USA), Inc. ("IPC") to reduce its working capital needs by outsourcing fuel sales. IPC did not file a UCC financing statement or otherwise perfect its interest in either the consigned fuel or the proceeds from the sale of such fuel.

IPC delivered consigned fuel to Pettit Oil's card lock sites for sale to Pettit Oil's customers. Pettit Oil instructed its customers to remit payments directly to IPC. However, some customers continued to pay Pettit Oil directly and Pettit Oil then forwarded these payments to IPC. Despite this business

practice, Pettit Oil was in possession of not only unsold consigned fuel provided by IPC, but also unremitted proceeds in the form of cash and accounts receivable arising from the sale of IPC's fuel, when Pettit had filed its Chapter 11 case.

Pettit Oil's Chapter 11 case was ultimately converted to Chapter 7, and a Chapter 7 trustee (the "Trustee") was appointed on January 17, 2014. On August 27, 2014, the Trustee commenced an adversary proceeding against IPC seeking, among other things, to avoid IPC's consignment interest in IPC's consigned fuel and the unremitted proceeds from the sale of the consigned fuel and recover the value of the consigned goods and proceeds for the benefit of Pettit Oil's bankruptcy estate. The Trustee claimed a prior interest in the consigned fuel and all unremitted proceeds from Pettit Oil's sale of the fuel because IPC had failed to perfect its consignment interest.

The bankruptcy court granted summary judgment in favor of the Trustee. IPC appealed to the Ninth Circuit's Bankruptcy Appellate Panel, which affirmed the bankruptcy court's decision. IPC then appealed to the Ninth Circuit. While IPC conceded the Trustee had a superior interest in the consigned fuel due to IPC's failure to perfect its consignment interest, IPC argued that it had retained a superior interest in the accounts receivable and cash proceeds from Pettit Oil's sale of the consigned fuel by virtue of IPC's consignment arrangement with Pettit Oil.

First, IPC argued that the proceeds of the consigned goods in Pettit Oil's possession were not owned by Pettit Oil and, therefore, were not property of Pettit Oil's bankruptcy estate and were outside the scope of the Bankruptcy Code's avoidance and recovery provisions. IPC also argued that it had a prior interest in the consigned fuel that enjoyed priority over the Trustee's rights to the proceeds of IPC's consigned goods, despite IPC's failure to perfect its consignment interest, according to UCC Article 9, because UCC Section 9-319 refers to only goods and not proceeds. As a result, Section 9-319 does not impact the rights of IPC and the Trustee to the proceeds of the fuel.

The Ninth Circuit's Decision

The Ninth Circuit upheld the Trustee's avoidance of IPC's consignment interest in both its consigned fuel and proceeds. The Ninth Circuit relied on UCC Section 9-319(a), which states that while consigned goods are in a consignee's possession, "the consignee is deemed to have rights and title to the goods identical to those the consignor had." In other words, UCC Article 9 treats the consignee as an owner of the consigned goods in its possession even though a consignor retains title to the consigned goods.

The Ninth Circuit rejected IPC's argument that UCC Section 9-319 applies only to the consigned goods, and not to their proceeds, because that interpretation of UCC Section 9-319 "ignores numerous references throughout the UCC that treat a consignment as a security interest for all practical purposes." The Ninth Circuit relied on UCC Section 9-324(b), which states that a perfected security interest in inventory has priority over competing interests in the same inventory and "also has priority in identifiable cash proceeds of the inventory." Therefore, a consignor that perfects its interest in its consigned goods has priority over a bankruptcy trustee in not only the goods, but also in the proceeds from the sale of such goods. The Ninth Circuit then reasoned that the inverse proposition—that a consignor who fails to perfect its interest

does not have priority over a bankruptcy trustee in either the consigned goods or their proceeds—should also apply.

The Ninth Circuit also noted that the legislative purpose behind the UCC's perfection rules support its finding that the Trustee has a superior interest in the proceeds of IPC's consigned fuel. UCC Article 9's perfection and priority rules, which, among other things, require a consignor to provide public notice of its security interest by filing a UCC financing statement that adequately describes its consigned goods, are intended to protect the consignee's other creditors from "secret liens" that, if known, would make such creditors wary of extending credit to the consignee. Allowing a consignor to enjoy priority in the proceeds of consigned goods in which the consignor had an unperfected interest would fly in the face of this policy rationale.

Conclusion

The *Pettit Oil* decision is a painful reminder to consignors that it is absolutely critical to perfect their consignment interests under the UCC. Much like a secured lender, a consignor seeking priority status in its consigned goods and their proceeds over the rights of a trustee of a consignee's bankruptcy estate should follow UCC Article 9's perfection rules by filing a UCC financing statement that adequately

describes the consigned goods and proceeds, and follow all of UCC Article 9's other rules for obtaining a prior interest in the goods and proceeds.

A consignor that fails to satisfy the UCC's requirements faces the prospect of having to engage in expensive and time-consuming litigation over its rights in the consigned goods and their proceeds and, ultimately, risks losing the very protections it had negotiated to mitigate its losses in the event the consignee files for bankruptcy. The consignor would have to prove that the consignee is generally known by its creditors to be substantially engaged in selling the goods of others, which would place the consignment transaction outside of UCC Article 9. Unfortunately for the consignor, this is very hard to prove and has left many an unperfected consignor out of luck!

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