

Consignment the Wrong Way: The Unfortunate Plight of the Unperfected Consignor



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A trade creditor seeking to mitigate the risk of nonpayment of its claim may opt to enter into a consignment arrangement with a distressed customer. A creditor that 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. A creditor that fails to satisfy the UCC's consignment requirements risks forfeiting any prior rights to its consigned goods and being relegated to asserting a low priority general unsecured claim against its customer.

The Chapter 11 bankruptcy cases of The Sports Authority Holdings, Inc. and its affiliated debtors (collectively, "Sports Authority") have provided numerous examples of how consignment-related disputes ultimately play out when litigated before a bankruptcy court. Recently, on April 12, 2019, the United States Bankruptcy Court for the District of Delaware, in *TSA Stores, Inc. et al. v. Sports Dimension Inc. a/k/a Body Glove ("Sports Dimension")*, ruled against one of Sports Authority's trade vendors that had failed to timely perfect its consignment interest. The court's decision illustrates the many hurdles and pitfalls facing a non-compliant consignor that fails to "dot its i's and cross its t's" when selling goods on consignment.

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 consignor and consignee are frequently parties to a consignment agreement that contains the terms of the consignment arrangement. 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. The consignee can return unsold or unused goods to the consignor if permitted 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 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. Whether Sports Authority was not generally known to be substantially engaged in selling the goods of others was at issue in the *Sports Dimension* case.

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. 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 priority interest in the consigned goods to those creditors of the consignee that obtain a judicial lien or security interest in the goods. A bankruptcy trustee and debtor-in-possession, as judicial lien creditors, would also enjoy priority over an unperfected consignor.

A consignor must do more than merely file a UCC financing statement to obtain a superior interest in its consigned goods. 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.

If a consignment transaction fails to meet the rigid definition of a consignment under UCC Section 9-102(a)(20), the consignor may still enjoy prior rights to its consigned goods if it can prove that the transaction is a "true consignment" under state law. True consignments are not governed by UCC Article 9; therefore, 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 as a condition for having priority status in the consigned goods.

Courts, including the Delaware bankruptcy court, have held that a true consignment exists where the consignor proves that (1) the consignee's creditors generally knew that the consignor was *substantially engaged* in selling the goods of third parties, such as consigned goods, or (2) the consignee's secured lender or other secured creditor had *actual knowledge* that the consignee had a consignment

arrangement with the consignor. There is a simple rationale for this; Article 9 of the UCC is supposed 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 unperfected consignor's interest is no secret to the lender, and the unperfected consignor would not run afoul of the notice requirements of UCC Article 9 in claiming priority over the secured lender's perfected blanket security interest in the consignee's inventory.

However, proving the existence of a true consignment is no easy task. The *Sports Dimension* case serves as a painful reminder that a consignor risks losing priority status with respect to its consigned goods unless the consignor satisfies the UCC's requirements for consignments.

The Facts of the Sports Dimension 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 bankruptcy court in Delaware. Prior to the Petition Date, in 2006, Sports Authority had entered into a secured lending facility that included a term loan, which, following a refinancing, had an outstanding principal balance of \$300 million. Bank of America ("BOA") was the administrative agent for the term loan lenders. The term loan, which was at issue in the *Sports Dimension* case, was secured by, among other assets, a second priority security interest in Sports Authority's inventory. 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. In December 2015, Wilmington Savings Fund Society ("WSFS") replaced BOA as the term lenders' agent. On the Petition Date, 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.

As part of its business, Sports Authority had developed a program for vendors to sell goods on consignment terms by entering

into "pay by scan" consignment agreements with Sports Authority. Sports Authority had paid its consignment vendors either a fixed amount for each item sold or a percentage of its retail sales price of goods sold.

In 2011, Sports Dimension had entered into a pay by scan consignment agreement with Sports Authority while BOA was the agent under the term loan. However, Sports Dimension did not file a UCC-1 financing statement covering its consigned goods until January 25, 2016, approximately one month before the Petition Date. Despite WSFS having succeeded BOA as the term lenders' agent prior to Sports Dimension's UCC-1 filing and WSFS having previously filed a UCC-1 financing statement, Sports Dimension failed to provide notice of its consignment to WSFS, as required by UCC Article 9.

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 a superior interest in the consigned goods.

On March 16, 2016, Sports Authority commenced an adversary proceeding against Sports Dimension, seeking a declaratory judgment regarding the priority of Sports Dimension'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 Sports Dimension's consigned goods was senior to Sports Dimension's unperfected consignment interest and (2) disgorgement of all payments that Sports Dimension had received from Sports Authority's sale of the consigned goods. Sports Dimension filed an answer and counterclaim, seeking a declaration that WSFS' security interest did not attach to Sports Dimension's consigned goods and that WSFS' lien was subordinate to Sports Dimension's consignment interest.

On September 10, 2018, the parties filed cross-motions for summary judgment regarding their respective interests in the consigned goods and their proceeds. WSFS argued that the consignment was subject to UCC Article 9. As such, and under UCC Article 9, WSFS' and the term lenders' interest in the consigned goods was superior to Sports Dimension's consignment interest because WSFS had filed its UCC-1 financing statement before Sports Dimension filed its financing statement, and Sports Dimension had failed to provide notice of its consignment interest to WSFS as required to obtain a prior interest in the consigned goods.

Sports Dimension argued that UCC Article 9 does not govern the priority of WSFS' (and the term lenders') and Sports Dimension's interests in the consigned goods because the consignment arrangement was a "true consignment". Sports Dimension contended that (1) Sports Authority's creditors generally knew Sports Authority was substantially engaged in selling the goods of others and (2) WSFS was actually aware of Sports Authority's consignment arrangement with Sports Dimension. Alternatively, Sports Dimension argued that even if the UCC had governed the consignment, Sports Dimension had satisfied the UCC's notice requirements by sending notice of its UCC filing to BOA prior to the Petition Date.

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

The bankruptcy court rejected each of Sports Dimension's arguments. Sports Dimension could not prove the existence of a true consignment arrangement that would have excused Sports Dimension from filing a UCC financing statement and complying with UCC Article 9's notice requirements.

The court concluded that Sports Authority was not "substantially engaged" in consignment transactions. WSFS and Sports Dimension stipulated that at no point in their business relationship did consigned goods comprise more than 14% of Sports Authority's inventory. Further, as the court noted, the term loan documents included a statement that consigned goods were an immaterial portion of Sports Authority's total inventory for sale. The court ultimately held that the threshold for "substantial

engagement" in selling the goods of others is met only if consigned goods comprise 20% or more of the value of a debtor's inventory. Since it was undisputed that less than 20% of Sports Authority's inventory was comprised of consigned goods, the court concluded Sports Dimension had failed to prove that Sports Authority's creditors generally knew Sports Authority was "substantially engaged" in selling the goods of others. The bankruptcy court also held that Sports Dimension did not prove that either WSFS or the term lenders had actual knowledge of Sports Dimension's consignment arrangement with Sports Authority.

Having determined that UCC Article 9 governed Sports Dimension's consignment arrangement, the court then rejected Sports Dimension's contention that it had satisfied UCC Article 9's requirement to send a notification of the consignment to all secured parties with a blanket security interest in all of Sports Authority's inventory. Quite simply, Sports Dimension messed up when it had failed to send notice of its consignment interest to WSFS, and had instead sent notice to the term lenders' predecessor agent, BOA. WSFS had filed a UCC-1 financing statement prior to Sports Dimension's UCC filing and, therefore, Sports Dimension was required to provide WSFS, and not the predecessor agent, BOA, notice of Sports Dimension's consignment interest in order to enjoy priority over WSFS and the term lenders. The bankruptcy court found no authority for excusing Sports Dimension from giving notice of its consignment interest to WSFS, particularly where there was no evidence that BOA had forwarded Sports Dimension's notice to WSFS.

Conclusion

Though Sports Dimension has filed an appeal, which remains pending, the *Sports Dimension* case highlights the importance of following the applicable requirements for perfection and priority under UCC Article 9. Litigating whether a consignment arrangement is governed by UCC Article 9's requirements is costly and potentially an uphill battle. Proving a secured creditor's knowledge of a consignor's specific consignment arrangement is very difficult. Likewise, proving a consignee is substantially engaged in selling consigned goods may be a factual impossibility if the value

of the consignee's consigned goods falls below the 20% threshold upheld by the Delaware bankruptcy court.

Indeed, in the March 2019 edition of *Business Credit* magazine, we discussed another recent decision in the Sports Authority bankruptcy cases involving a different unperfected consignor, Performance Apparel Corp. ("PAC"). The court had upheld PAC's prior rights to its consigned goods where PAC had proved that BOA and the secured term lenders were aware of PAC's consignment arrangement when the term loans were made to Sports Authority. As a result, the court characterized PAC's arrangement with Sports Authority as a true consignment that was not governed by UCC Article 9. However, as we had previously pointed out, the lenders' term loan agreement explicitly referenced PAC's consignment interest and PAC had a UCC financing statement describing its consigned goods on file when the term loan was extended to Sports Authority. Without such clear-cut facts, it would have been very challenging for PAC to prove a true consignment.

It is critical that a prospective consignor familiarize itself with its consignee's business and relationships with other secured creditors to determine whether the UCC applies by determining what portion of the consignee's business relates to consigned goods and whether other secured creditors are aware of the prospective consignment arrangement. Further, if the UCC applies, best practices require that a consignor not only file a UCC-1 financing statement as soon as possible, but also conduct a UCC search and give notice to any other creditors that have filed UCC-1 financing statements covering all of the consignee's inventory. Failure to conduct this due diligence and provide requisite notice can prove quite costly where the consignor is tasked with defending the priority of its consignment interest.

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